

Submission
No 22

INQUIRY INTO ABILITY OF LOCAL GOVERNMENTS TO FUND INFRASTRUCTURE AND SERVICES

Organisation: United Services Union

Date Received: 22 April 2024

22 April 2024

Emily Suvaal
Chair
Standing Committee on State Development

By your side



Dear Chair

Ability of local governments to fund infrastructure and services

We write to you in response to the above inquiry and the relevant terms of reference distributed by your Committee.

The United Services Union has nearly 30,000 members across New South Wales, and we have represented workers in local government for more than 120 years. We have members working in every town and community in the state, doing every job within local government up to and including council General Manager.

We genuinely believe that a vibrant and sustainable local government sector is necessary for the well-being and prosperity of the people of New South Wales. Council workers fix roads, manage libraries, collect rubbish, maintain parks and reserves, look after children, run community events and complete scores of other vital tasks that make our communities what they are.

However, over recent decades we have seen these services put at risk as unsustainable and unrealistic funding models have been imposed upon NSW councils. At the same time, the economically damaging policy of rate capping has exacerbated the underlying financial difficulties faced by councils, leaving local government with a legacy of debt and underinvestment in assets and infrastructure.

Urgent action is required to address these issues and ensure the long-term viability of local government in New South Wales. To that end, the USU has commissioned independent research from Professor Brian Dollery, a respected academic in his field, to provide your Committee with expert and impartial responses to your terms of reference.

Professor Dollery's report, as well as earlier works of Professor Dollery on related matters, are enclosed for the Committee's reference.

The USU looks forward to working with the Committee to answer the terms of reference and improve the sustainability and outlook of NSW local government.

Regards,

GENERAL SECRETARY

UNITED SERVICES UNION

NSW LOCAL GOVERNMENT, CLERICAL,
ADMINISTRATIVE, ENERGY, AIRLINES
AND UTILITIES UNION

Standing Committee on State Development

***New South Wales Inquiry
into the Ability of Local
Governments to Fund
Infrastructure and Services***

United Services Union Submission

Contact:**Disclaimer**

This Report was prepared by Brian Dollery on behalf of New England Education and Research Proprietary Limited for the United Services Union (USU). This Report was produced for the USU as a strictly independent Report. The opinions expressed in the Report are thus exclusively the views of its author and do not necessarily coincide with the views of the USU or any other body. The information provided in this Report may be reproduced in whole or in part for media review, quotation in literature, or non-commercial purposes, subject to the inclusion of acknowledgement of the source and provided no commercial use or sale of the material occurs.

1. Introduction

On 21 March 2024, the NSW House of Representatives Standing Committee on Regional Development Infrastructure and Transport announced an *Inquiry into the Ability of Local Governments to Fund Infrastructure and Services*. The new Inquiry will consider a range of matters, including financial sustainability and funding, evolving infrastructure and service delivery obligations, as well as workforce attraction and retention and labour hire practices.

The formal Terms of Reference for the Inquiry are as follows:

‘That the Standing Committee on State Development inquire into and report on the ability of local governments to fund infrastructure and services, and in particular:

- (a) The level of income councils require to adequately meet the needs of their communities
- (b) Examine if past rate pegs have matched increases in costs borne by local governments
- (c) Current levels of service delivery and financial sustainability in local government, including the impact of cost shifting on service delivery and financial sustainability, and whether this has changed over time
- (d) Assess the social and economic impacts of the rate peg in New South Wales for ratepayers, councils, and council staff over the last 20 years and compare with other jurisdictions
- (e) Compare the rate peg as it currently exists to alternative approaches with regards to the outcomes for ratepayers, councils, and council staff
- (f) Review the operation of the special rate variation process and its effectiveness in providing the level of income Councils require to adequately meet the needs of their communities
- (g) Any other related matters’.

In this submission, we address items (a) to (g).

2. Addressing the Terms of Reference

(a) The level of income councils require to adequately meet the needs of their communities

The NSW local government system comprises different categories of local council with differential revenue-raising capacities and significant disparities in local service provision, which face substantial spatial variations in input costs. Accordingly, metropolitan councils, regional councils, rural councils and remote councils face different fiscal challenges in providing adequate services to their respective local communities (Dollery, Crase and Johnson 2006; Dollery, Wallis and Allan 2006; Dollery, Kortt and Grant 2013). It is thus not possible to calculate a common adequate level of income for NSW local councils.

The question of an ‘adequate’ municipal income has numerous different dimensions. Firstly, aggregate income for all NSW local authorities is not the problem. Rather the distribution of income amongst local councils is problematic. This derives from a host of factors, including (a) grant allocations that are inadequate or incorrectly calculated; (b) local councils that have different socio-economic characteristics and hence different capacity to raise income through property taxes and fees and charges, with small rural councils typically the least able to raise adequate ‘own-source’ revenue; and (c) large differences in the revenue effort exerted by various NSW councils as a result of differences that existed back in 1975, compounded by five decades of rate-capping and demographic changes over time (Drew and Dollery 2015b).

Secondly, over the past several decades there has been a substantial change in the composition of local government service provision, characterised chiefly by a shift from ‘services to property’ to ‘services to people’ (Dollery, Wallis and Allan 2006). In essence, local councils are providing a growing quantum of discretionary goods and services, whilst simultaneously often ignoring basic needs, such as road re-sealing.

Thirdly, most NSW local councils do not levy fees and charges in line with production costs - or Long-Run Marginal Costs (LRMC) - and thus fees and charges often do not reflect the costs of service provision. Indeed, at present, municipal accounting weaknesses mean that most councils are not able to accurately identify the actual cost of providing most of the goods and services that they provide (Drew and Dollery 2015b).

Remedial policy measures are necessary to address these and other problems in municipal finance in the NSW local government system (Dollery, Kortt and Grant 2013). For example, what is required is for councils to extract a consistent revenue effort across the state, charge

prices at LRMC, and for a competent local government grants regime to make up the horizontal fiscal equalisation (HFE) differences between local councils. Moreover, the abolition of rate-pegging, or at least a much more flexible rate-cap methodology, is required (Dollery 2022).

(b) Examine if past rate pegs have matched increases in costs borne by local governments

At present, municipal costs in NSW local government are calculated by means of the Local Government Cost Index (LGCI). The LGCI measures price changes over a given year for goods, materials and labour employed by an ‘average council’. Specifically, the LGCI computes the average change in prices of a fixed ‘basket’ of goods and services employed by local councils relative to the prices of the same basket in a base period. The LGCI has 26 cost components, encompassing *inter alia* worker benefits and on-costs, together with building materials for bridges, footpaths and roads. These cost components embody the purchases made by an average local council to conduct its ‘typical activities’. In its LGCI calculation process, the Independent and Pricing Regulatory Tribunal (IPART) uses Australian Bureau of Statistics (ABS) price indexes for wage costs, producer prices and consumer prices. In computing these price indexes, the ABS includes quality adjustments in its price measures to accommodate increases in capital and labour productivity.

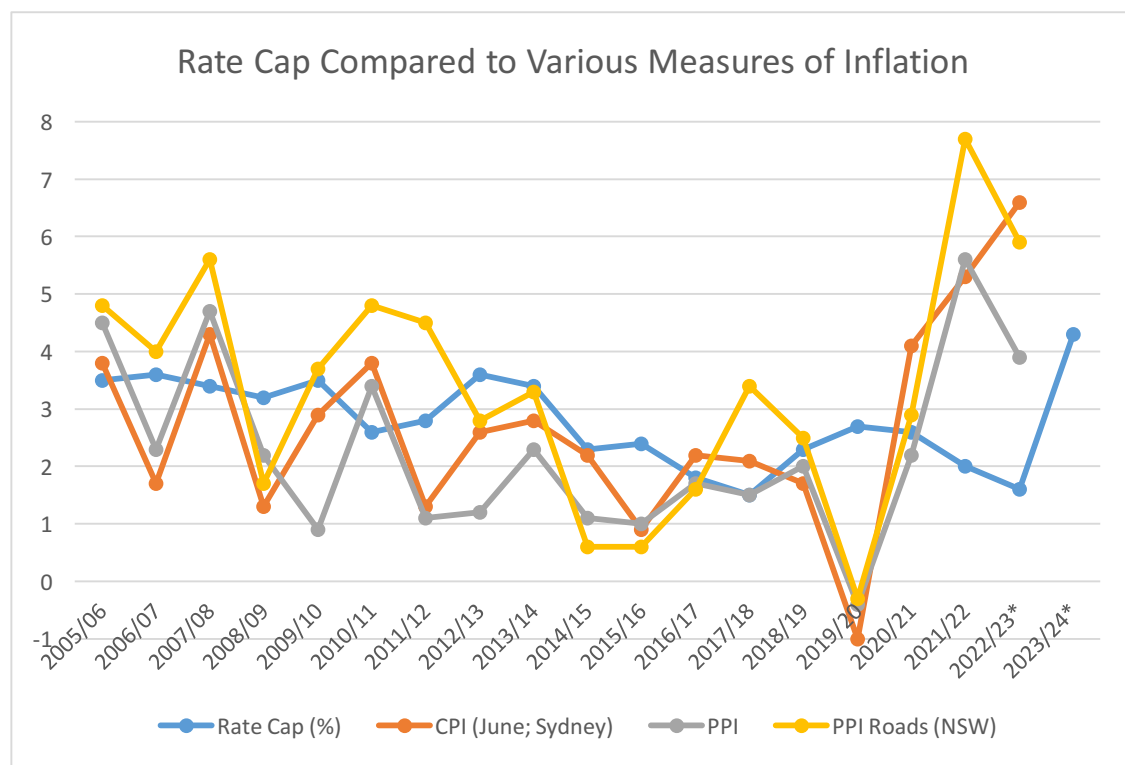
Use of the LGCI as a proxy for NSW local government cost escalation is problematical for several reasons. Firstly, different categories of local council, such as metropolitan councils, regional councils and rural councils, do not use the same input mix or basket of goods and services to provide their respective services given that the composition of their services differs. For example, in the Greater Sydney region, Sydney Water provides water and wastewater services, whereas in non-metropolitan NSW these services are largely supplied by local councils.

Secondly, metropolitan councils, regional councils and rural councils often face different cost structures for many of the resources they employ in service delivery, given the considerable spatial variation in costs that exists across NSW. In general, rural and remote councils typically bear higher costs than their metropolitan and regional counterparts.

Given the fact that input costs differ between different categories of local council, as well as between different geographical areas across NSW, it is thus not possible to generalise across the entire NSW local government system on the precise nature of the relationship between increases in municipal costs and adjustments to the rate-peg.

However, in recent work he did for the Federation Council, Professor Joseph Drew (2024) produced a useful graph (Figure 1) that aptly illustrates the deficiencies in the NSW rate-cap in terms of the level of the rate-peg, the Consumer Price Index (CPI), the Producer Price Index (PPI) and the PPI for Roads (PPI (Roads)). The PPI (Roads) is included in the graph since roads represent the most substantial component of NSW council costs. It should be noted that for the final two years covered by the graph, the rate-cap was a range and that some councils actually received less than illustrated.

Figure 1



As Drew (2024) has observed, the CPI has heavily influenced the IPART rate-cap determination. Moreover, it continues to be dominated by the CPI. Given the fact that CPI projections are often less accurate in a high inflation environment, post-2019/20 rate-peg determinations are more likely to be problematical.

Furthermore, as noted, the largest single item of municipal expenditure is local roads (Drew 2022). It is evident from the diagram that the PPI (Roads) is consistently above the rate-cap.

(c) Current levels of service delivery and financial sustainability in local government, including the impact of cost shifting on service delivery and financial sustainability, and whether this has changed over time.

Terms of Reference item (c) raises multifaceted dimensions of local government performance. In the interests of clarity, discussion falls into three main parts: the changing nature and composition of municipal service provision; financial sustainability; and cost shifting.

The Changing Nature and Composition of Local Government Service Provision

Australian local councils have traditionally provided a comparatively narrow range of local services, mostly ‘services to property’, financed through a complex mix of property taxes, grants, and fees and charges. However, over time, the amendment of the different Local Government Acts across all Australian state and territory local government systems has created the legislative scope for a much greater role for local municipalities (Dollery, Crase and Johnson 2006). As a result, the power of general competence embodied in these statutes has expedited a dramatic transformation of the composition of municipal service provision away from traditional ‘services to property’ towards ‘services to people’.

Changes in the composition of municipal service provision have been occurring for several decades. For instance, in 2003, the Commonwealth Hawker Report (2003, p.9) observed that there had not only been increasing diversity across Australian local government service provision, but also an ‘expansion of the roles beyond those traditionally delivered by the local sector’. This shift in emphasis in service provision had two main characteristics: (a) Local authorities were assuming responsibility for more social issues, including ‘health, alcohol and drug problems, community safety and improved planning and accessible transport’; and (b) local councils were increasingly active in the application and monitoring of regulation, especially in ‘development and planning, public health and environmental management’ (Hawker Report 2003, p. 9).

Similarly, in its *Local Government National Report, 2003-04*, the (then) Commonwealth Department of Transport and Regional Services (DOTARS 2007, p.2) also recognized the ongoing changing role of Australian local government, noting that local authorities were ‘increasingly providing services above and beyond those traditionally associated with local government’ (DOTARS 2007, p. 2). It observed that ‘local government now delivers a

greater range of services, broadening its focus from “hard” infrastructure provision to spending on social services, such as health, welfare, safety, and community amenities’.

The Commonwealth Grants Commission (CGC 2001) calculated trends in the composition of municipal outlays across Australian local government by function over the period 1961/62 to 1997/98. It found that councils had expanded human service functions sharply relative to their longstanding ‘services to property’ focus over a 35-year time period. For example, ‘general public services’ fell from slightly in excess of 20% of expenditure in 1961/62 to around 13% in 1997-98. The decline in ‘transport and communication’ was even more pronounced.

The CGC (2001) ascribed four main characteristics to the observed changes in the composition of local government expenditure:

- (a) It comprised a continuous shift from ‘property-based services to human services’.
- (b) The relative weight of ‘recreation and culture’ and ‘housing and community amenities’ had increased to about 20% of expenditure in each case.
- (c) Expenditure on roads declined from more than 50% in the 1960s to just over 25% by 1997/98.
- (d) Expenditure on ‘education, health, welfare and public safety’ expanded (CGC 2001, pp. 53-54).

The CGC (2001, p.54) concluded that ‘the composition of services being provided by local government has changed markedly over the past 30-35 years’. In essence, ‘local government is increasingly providing human services at the expense of traditional property-based services (particularly roads)’.

These trends appear to have continued. For example, the Allan Report (2006) observed that changes in NSW local government expenditure since 1995/96 exhibited three main characteristics:

- (a) The ‘fastest growing activities have been housing and community amenities, public order and safety, and economic affairs, particularly within Sydney City’.
- (b) ‘Transport and communications (largely road maintenance and depreciation, though not necessarily renewal) had a marked increase in 1996-97, but has stabilized since then’.

(c) ‘Health’ and ‘mining, manufacturing and construction’ both fell relative to the Consumer Price Index. (Allan Report, 2006, Ch. 7, p. 153).

It is thus evident that a longstanding and significant change has occurred in the composition of the services provided by Australian local government, including the NSW local government system. However, a caveat to this conclusion is required. These aggregate trends in the service mix disguise a high degree of diversity in municipal service provision between different local government systems across Australia, between metropolitan, regional, rural and remote local authorities, and between individual councils within each of these categories. For instance, water and wastewater services are a local government responsibility in some Australian jurisdictions, but not in others. In NSW local government, water services are delivered mostly by water utilities in large urban conurbations, but often by local councils themselves in regional, rural and remote areas. Similarly, local councils spatially distant from major urban centres often provide services previously supplied by Commonwealth agencies, state governments or the private sector, such as aged-care facilities, postal services, banking services and even undertaker services (see, for example, Dollery, Wallis and Akimov 2010; Dollery, Wallis and Allan 2006).

In NSW local government, the 2016 compulsory council amalgamation program generated substantial additional local service provision in forcibly amalgamated local councils through service ‘harmonisation’ across new enlarged local government entities as the range and level of service provision had to be equalised for all residents (Drew, McQuestin and Dollery 2023). Harmonization costs in this context refer to the expense of equalizing both the salaries and services across the former constituent council entities. Previously, local government services of the constituent entities had typically differed according to the particular tastes expressed by the local community in question, as well as in consequence of differential service capacities.

Once a municipal merger has been completed, it is reasonable for local residents to demand equal service standards, especially if property rates, fees and charges have been harmonized. Given the political risks associated with reducing service levels following a forced merger, local service levels tend to increase. In the case of the 2016 NSW amalgamation program, Drew, McQuestin and Dollery (2023) found that the costs of service provision in the new entities increased, in part due to service harmonisation.

Financial Sustainability in Local Government

Financial sustainability has come to occupy an important role in contemporary public policy discourse and this is reflected in the local government literature. While the concept of financial sustainability has much to offer the analysis of local government, especially the fact that it obliges scholars and practitioners alike to consider the inter-temporal dimension of local government policy-making, significant difficulties exist in giving precise meaning to the term in the local government milieu.

The genesis of contemporary concern with local government financial sustainability in Australia occurred in the Commonwealth Grants Commission (CGC 2001) annual report *Review of the Operation of Local Government (Financial Assistance) Act 1995*. The CGC (2001, pp. 52-53) identified five main reasons for the acute level of financial stress faced by many Australian local authorities, especially in non-metropolitan areas: (a) The devolution of responsibility for service delivery from higher tiers of government; (b) ‘cost shifting’ from higher tiers of government onto local government; (c) the increased complexity and standard of local government services mandated by state government regulation; (d) ‘raised community expectations’ of municipal services; and (e) ‘policy choice’ involving the voluntary improvement and expansion of municipal services by local councils themselves.

This analysis is by no means complete. For example, as Johnson (2003) has observed, the CGC (2001) list does not include the fact that local councils have also added to these financial problems by artificially holding their rates and charges at unsustainably low levels. The CGC (2001) list also ignores ‘internal’ governance and management factors that are potentially crucial. Nevertheless, the CGC report did serve to lay the foundations for subsequent investigations into local government financial sustainability.

In the Australian local government context, the pioneering PriceWaterhouseCoopers (PWC 2006, p.95) *National Financial Sustainability Study of Local Government* offered a useful definition of ‘financial sustainability’: ‘The financial sustainability of a council is determined by its ability to manage expected financial requirements and financial risks and shocks over the long term without the use of disruptive revenue or expenditure measures’. This involves two elements: (a) Councils should maintain ‘healthy finances’, given current expenditure and revenue policies and foreseeable future developments; and (b) councils must ensure infrastructure expenditure ‘matches’ asset planning.

With respect to the practical application of this definition, PWC (2006) applied it to a stratified sample of 100 local authorities using five financial KPIs:

- ‘Operating surplus’ represented ‘total operating revenue less total operating expenses’. If an operating deficit exceeded 10% of total revenue, then it placed the local council at financial risk.
- ‘Interest coverage’ measured a council’s ability to pay interest on its debt and was calculated as the ratio of ‘Earnings before Interest and Tax’ (EBIT) to ‘borrowing costs’. A ratio value below 3 indicated financial unsustainability.
- ‘Sustainability ratio’ (or the ratio of capital expenditure to depreciation) measured changes in the asset base of councils. If the ratio exceeded unity, then the asset base was increasing. However, the PWC Report (2006, p. 97) stressed that the sustainability ratio must be ‘interpreted with care’ due to inconsistent asset valuation procedures.
- ‘Current ratio’ (or the ratio of current assets to current liabilities) measured a council’s capacity to meet its short-term debt obligations. A sustainable council must have a current ratio at least equal to unity.
- ‘Rates coverage’ represented total rates revenue as a proportion of total costs. An arbitrary ‘benchmark’ of 40% indicated ‘adequate self-funding’.

The PWC (2006) national report found that there was a national local government infrastructure backlog ranging between \$12.0 billion and \$15.3 billion, with an annual shortfall in expenditure on existing local infrastructure renewal of between \$0.9 billion to \$1.2 billion. This implied that between \$1.8 billion and \$2.3 billion per annum would be required to address the (then) deficit in maintenance spending on existing infrastructure and eliminate the current local infrastructure backlog. This represented the equivalent of between \$2.6 million and \$3.3 million per council per annum, which was far beyond the financial capacity of the vast majority of Australian local councils in 2006.

A substantial scholarly effort has also investigated financial sustainability in local government at a system-wide level and at the local municipal level (see, for example, Dollery, Kortt and Grant 2013; Farvacque-Vitkovic and Kopanyi 2014; Bisogno, Cuadrado-Ballesteros and García-Sánchez 2017; Dollery, Kitchen, McMillan and Shah 2020, for surveys of this literature). Although financial sustainability involves almost all dimensions of local government, the scholarly literature has concentrated on the empirical investigation of certain aspects of financial sustainability, especially operating performance,

financial flexibility, financial solvency and liquidity management, despite the potential impact of other factors, such as administrative intensity. Australian empirical research has covered all of these dimensions of financial sustainability, including a recent study of the impact of administrative intensity on financial sustainability in NSW local government (Yarram, Tran and Dollery 2024),

Empirical scholars have examined the impact of the 2016 NSW compulsory municipal amalgamation program on the financial sustainability of NSW local councils, especially those local councils that were forcibly merged (Drew, McQuestin and Dollery 2021; 2023). Drew, McQuestin and Dollery (2021) found that after four full financial years, the NSW forced amalgamation program had clearly damaged the financial sustainability of affected councils, especially in terms of significant and persistent increases to unit costs.

In the material that follows, we present some graphs drawn from data that gives us grounds for grave concern regarding financial sustainability in contemporary NSW local government. All these graphs were obtained from Professor Drew who has compiled an extensive database for the period 2008 to 2023 inclusive. The data is sourced from the notes of audited financial statements, OLG time series data on number of assessments, Grants Commission data on road lengths and demographic data from the *ABS Data by Region* reports. Professor Drew explains each graph in detail in the relevant videos at his YouTube channel *Professor Joseph Drew*. It is noted that this is a community service that Professor Drew offers in his own time with his own resources and does not form part of his remunerated academic duties.

The graphs are presented for the entire state of NSW and then disaggregated to (a) urban councils and (b) rural councils. This classification of councils is in accordance with the Australian local government classification system and is important because urban and rural councils differ markedly in terms of both the services they provide, as well as their potential sources of revenue to fund these services.

The first set of graphs that we will examine relate to the level of unrestricted cash typically held by NSW local governments [Professor Drew explains these graphs in the video at <https://www.youtube.com/watch?v=6T2bWQp2FVU>]. Unrestricted cash refers to those funds not earmarked for a particular purpose or not restricted by law. In essence, it represents money that local governments might use to plug deficits or meet unexpected expenses. A general rule of thumb is that councils ought to have two to three months of

cash expenses available in their unrestricted cash. However, it is alarming to note that a number of councils in NSW currently have negative unrestricted cash.

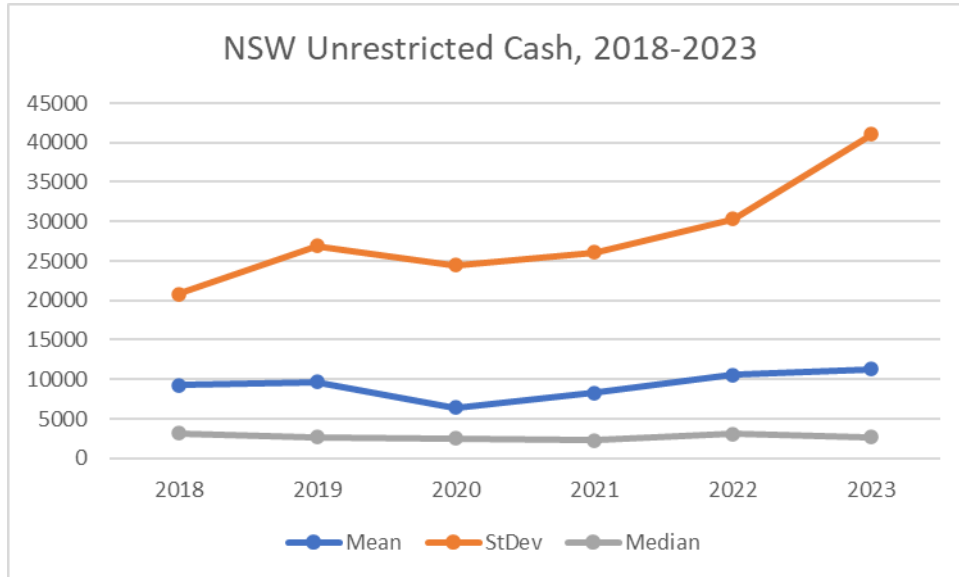
Figure 2 presents the data in nominal terms for the whole state for a period of six years. Three measures relating to central tendency are used to provide a comprehensive picture. The median (grey line) is the middle number after putting all the data in ascending order. When data is skewed by particularly large or small data points, then the median tends to be the most reliable measure of typical performance. The mean or average (blue line) is the sum of all the data points for a given year, divided by the number of councils. We note that for the most recent year we are still missing the data for twelve councils due, for the most part, to extraordinary and inexplicable delays by the NSW Auditor-General. This is very concerning because the councils which are still missing audited financial data (more than nine months after the completion of the relevant financial year) tend to be the ones in the most difficult position. The orange line is the standard deviation, which in simple terms is a measure of the average spread in the data. The standard deviation provides important information regarding the distribution of individual councils with respect to the mean; when the standard deviation is high (as it is in Figure 2), then it tells us that there is a great gulf between the councils at the bottom end of the distribution and those at the top. Otherwise stated, with a large standard deviation we know that results will diverge significantly from the average.

Figure 2 shows us that there is a relatively large gap between the mean and the median, which suggests skewing by some particularly high or low numbers. This is reinforced by the standard deviation that is extremely high and further suggests that there is a wide gulf between the councils at the bottom end of the distribution relative to those at the top. With respect to the councils at the bottom end of the distribution, we note that there are far too many councils with negative unrestricted cash and that these entities are in a perilous situation, especially if they are projecting or recording deficits. Indeed, we wonder why these councils are not taking strident measures to reverse matters and indeed are not being provided with intensive mentoring and advice from the OLG or IPART.

In general, the data should be a cause for concern because cash levels ought to be increasing, at least in line with inflation. There is even more reason to be concerned when one reflects on the fact that there are still a large number of councils which are not restricting prepaid Financial Assistance Grants (FAGs)(according to the 1995 Commonwealth legislation).

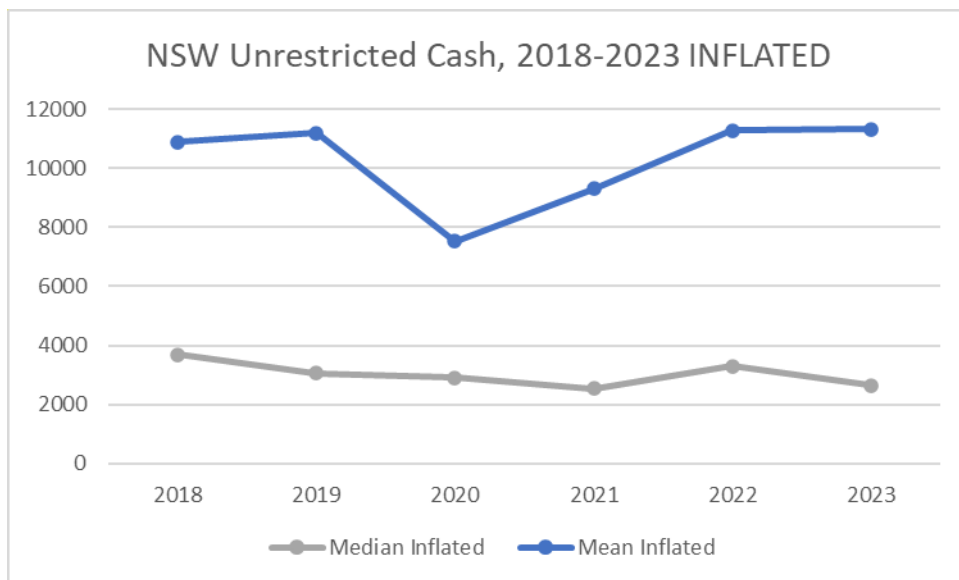
Moreover, as noted earlier, we are missing some twelve councils due to audit delays and these councils tend to be struggling.

Figure 2



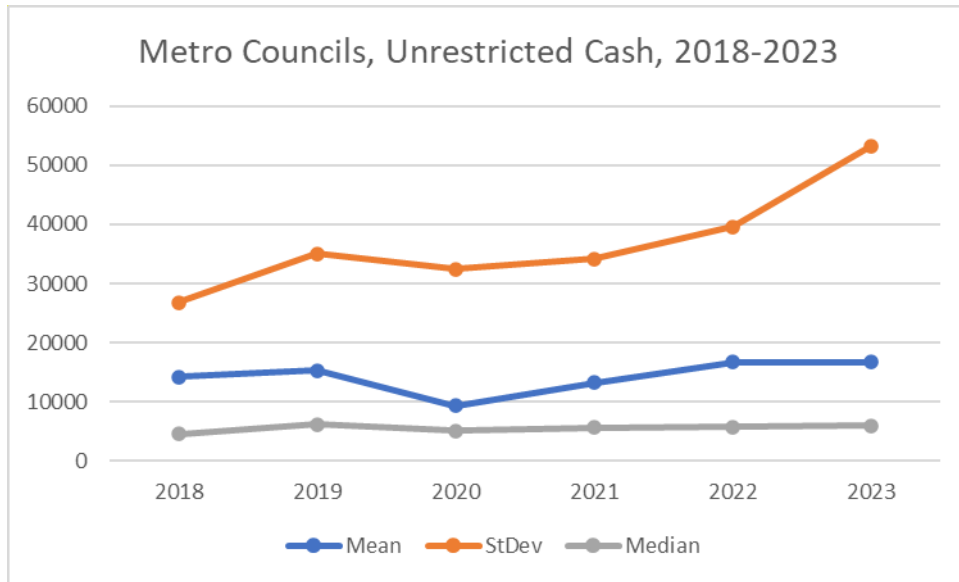
To make matters clearer, in Figure 3 we have inflated data to 2023 dollar terms using the appropriate ABS index numbers. It is now clear that matters are deteriorating at an alarming rate.

Figure 3



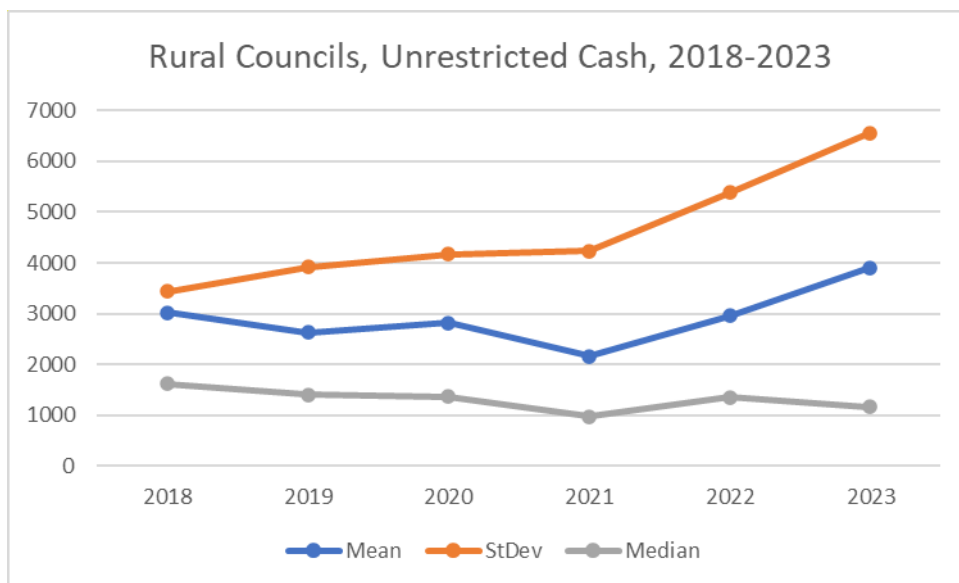
In Figure 4, we look at just the urban councils, which are characterised by a good deal of spread that has widened substantially in recent years. This confirms that there is a significant difference between councils relative to the typical result.

Figure 4



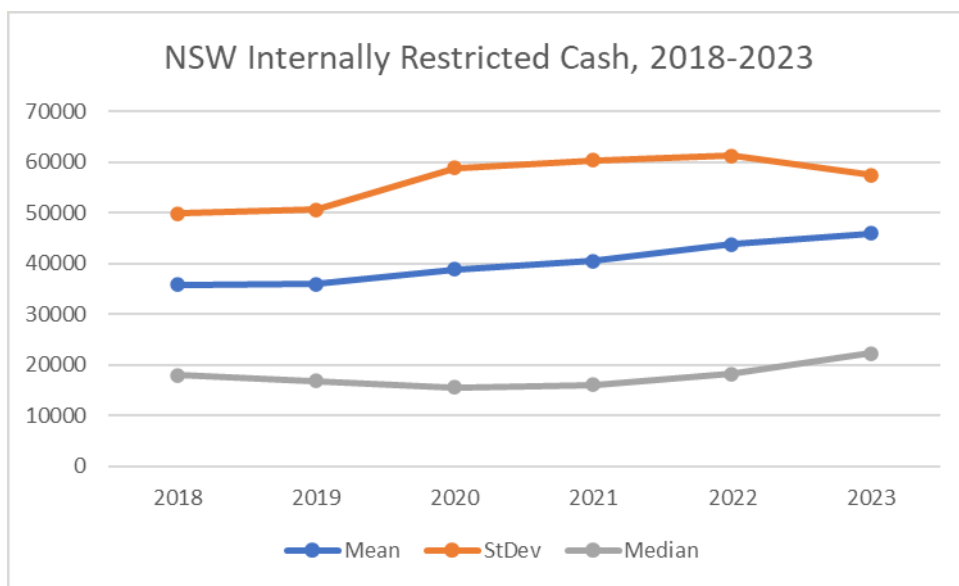
In Figure 5, we present the data for rural councils. It should be noted that the axis (in thousands of dollars) is around ten times smaller in magnitude. In addition, it is clear that skewing is a much bigger problem for the rural cohort, in common with the gap in the distribution of results.

Figure 5



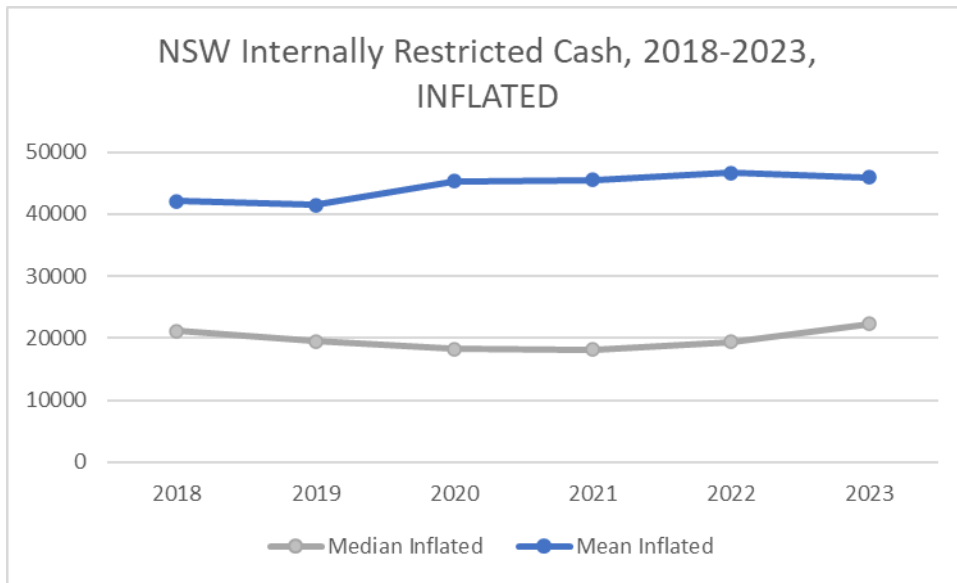
In Figure 6, the standard deviation for internally restricted cash is higher than it is for unrestricted cash, although so are the mean and median. Internally restricted cash includes important items such as staff entitlements and garbage tip remediation monies. Many councils also internally restrict prepaid FAGs and, given recent stretches to the duration of these, we would expect upward sloping lines. Once again, there is a noticeable difference between the median and mean that suggests a good deal of skewing.

Figure 6



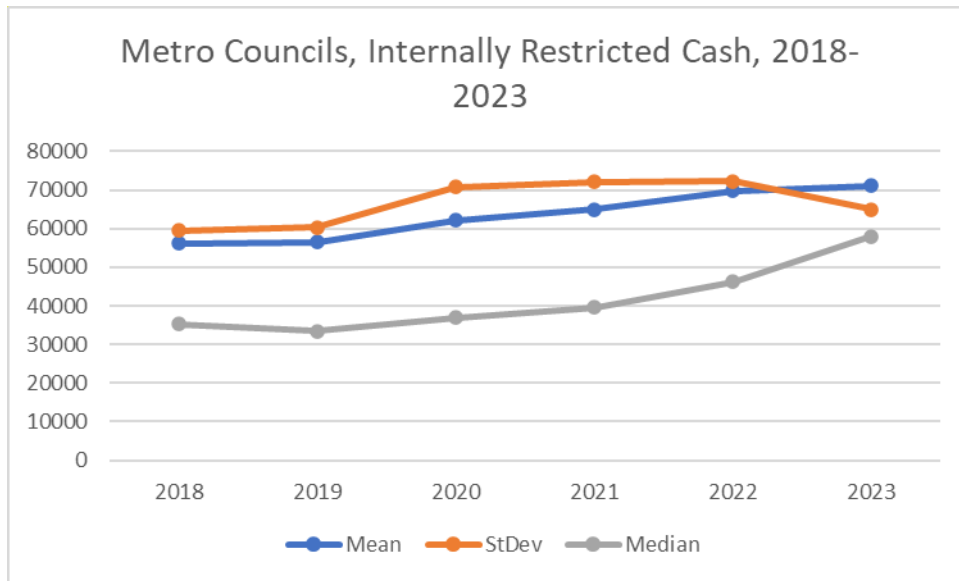
When we inflate the nominal data, as we can see in Figure 7, we quickly find that things are for the most-part flat, which is a big concern given the prepayment of FAGs, as well as the fact that staff liabilities tend to increase in line with pay increases which have been significant of late.

Figure 7



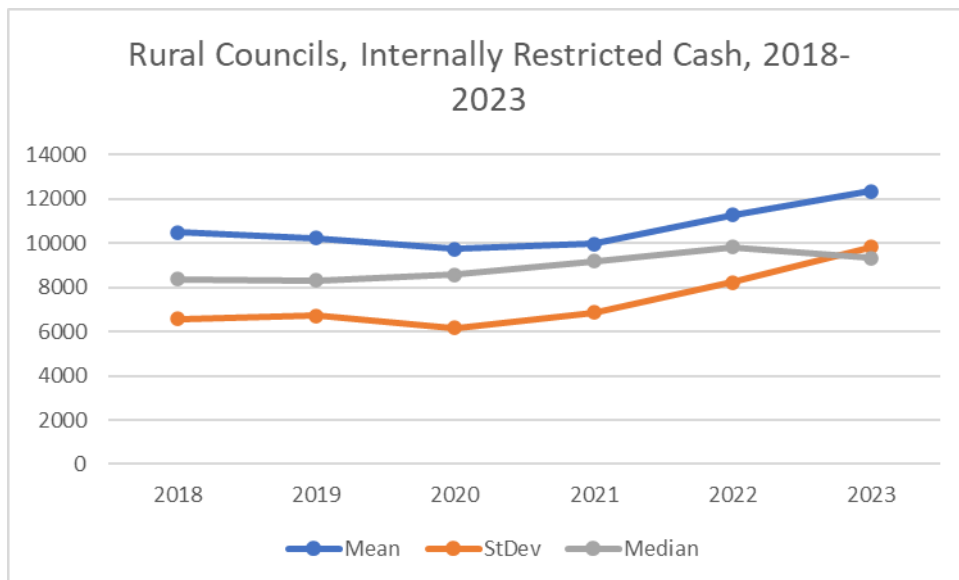
For urban councils, the most notable feature in Figure 8 is a narrowing in the gap between the mean and the median, echoed by a decline in the standard deviation. In general, this particular part of the trend is desirable – unlike with unrestricted cash, we are not seeing the ‘have nots’ decline at the same time as the ‘haves’ grow.

Figure 8



In Figure 9, the effect is even more noticeable in rural councils, which is broadly to be expected given their particular characteristics. However, setting aside the pleasing convergence between individual councils, the overall picture for internally restricted cash is still concerning.

Figure 9



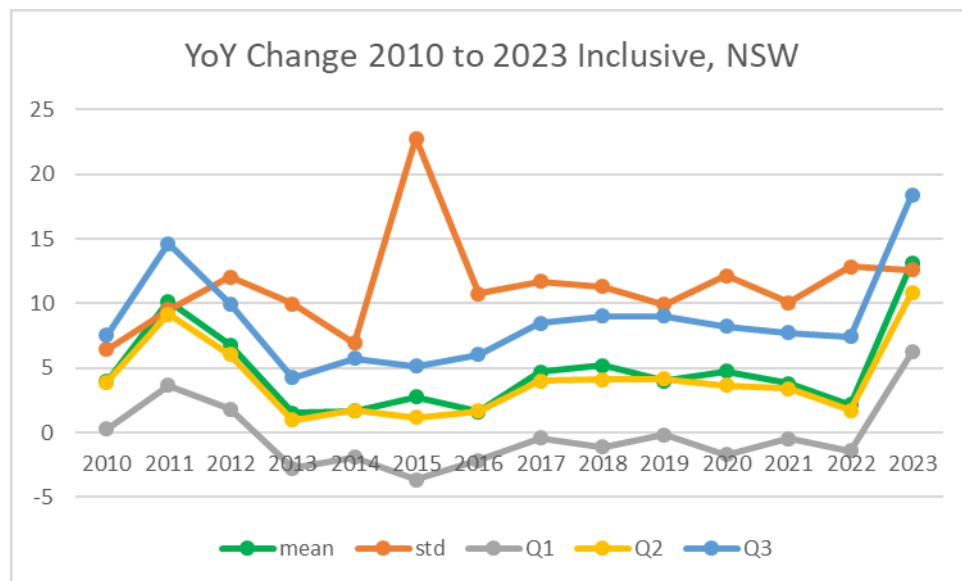
What is even more concerning is the dramatic increase in unit costs, which have not been matched at all by increases in rates or grants. [Professor Drew presents this data at <https://www.youtube.com/watch?v=CL989GPoW98>].

Unit cost is best measured for an analysis of this kind by dividing cash expenses by the total number of assessments. A complete analysis would employ Data Envelopment Analysis (DEA) or Full Disposable Hull (FDH) analysis, but this has not yet been undertaken.

Figure 10 provides various measures of central tendency relating to an account of the year-on-year percentage change in unit costs. The low is notable for occurring proximate to the Fit For The Future (FFTF) debates which dampened spending in line with the prevailing focus at the time on financial sustainability and prudent stewardship (although there was also a good deal of manipulation of accounting accrual data around this time as evidenced in Drew (2017) and Drew and Grant (2017)). The recent spike in the most recent financial year data is extremely concerning and it is the highest since at least 2010. It should also be recalled that we are missing the data from some dozen councils because of NSW Auditor-General delays.

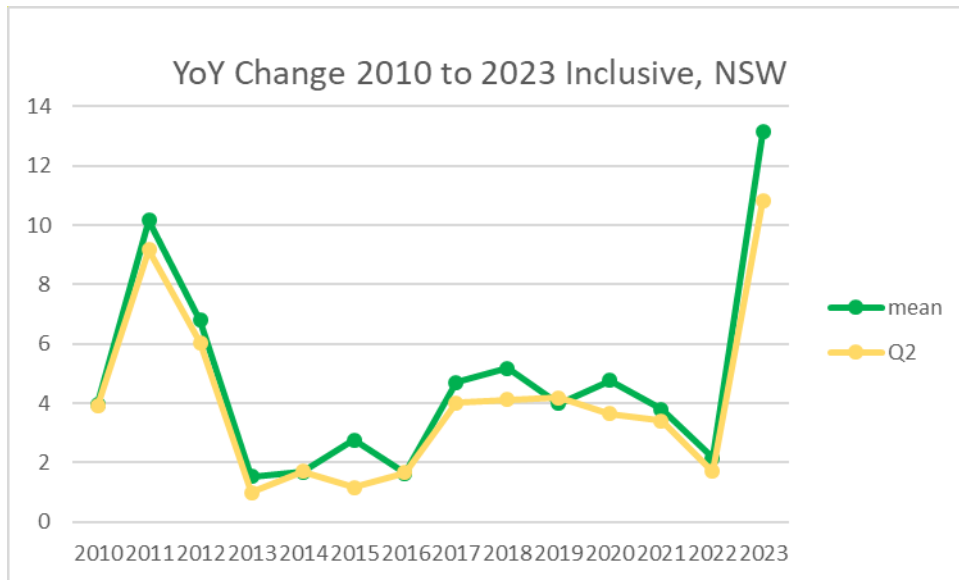
Needless to say that revenue increases have not kept pace with expenditure, which explains much of our earlier data on cash levels. This disparity cannot be accommodated over the long-term without a crisis occurring for many councils, or indeed the sector as a whole. Please note here that Q1 is quartile 1 (the middle point of the first half of the data whereby twenty-five percent of data points fall below this level) and Q3 is quartile 3 (the middle point of the top half of the data which is exceeded by twenty-five percent of councils).

Figure 10



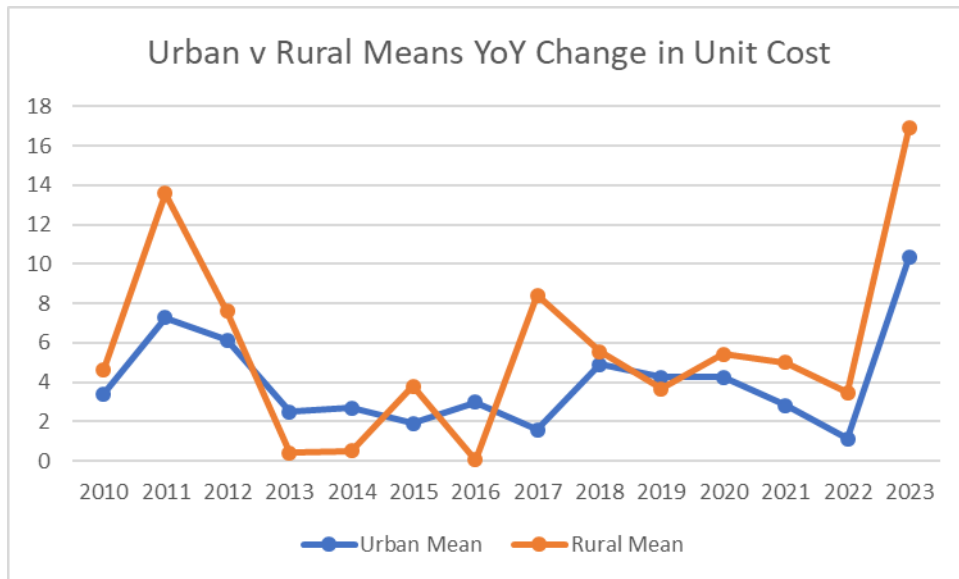
Stripping out the various additional measures of central tendency (Figure 11) renders matters even starker. It is noteworthy that here the median corresponds closely to the mean, which suggests that both are good measures of typical outcomes in this particular case.

Figure 11



In Figure 12, we present a comparison of the means for urban and rural councils respectively, with respect to year-on-year change in unit cost. A common theme throughout these graphs is that rural councils are suffering disproportionately relative to their urban peers. Proportionately larger infrastructure responsibilities (mostly roads), less potential to extract non-rate revenue, chaotic and dysfunctional grant allocation, and the rural forced amalgamations have hit this part of the sector especially hard and many councils are now well on the way to fiscal ruin. However, it should be noted that several peer reviewed studies have shown that rural councils are, on the whole, considerably more technically efficient than their urban peers (see, for example, Drew (2022)).

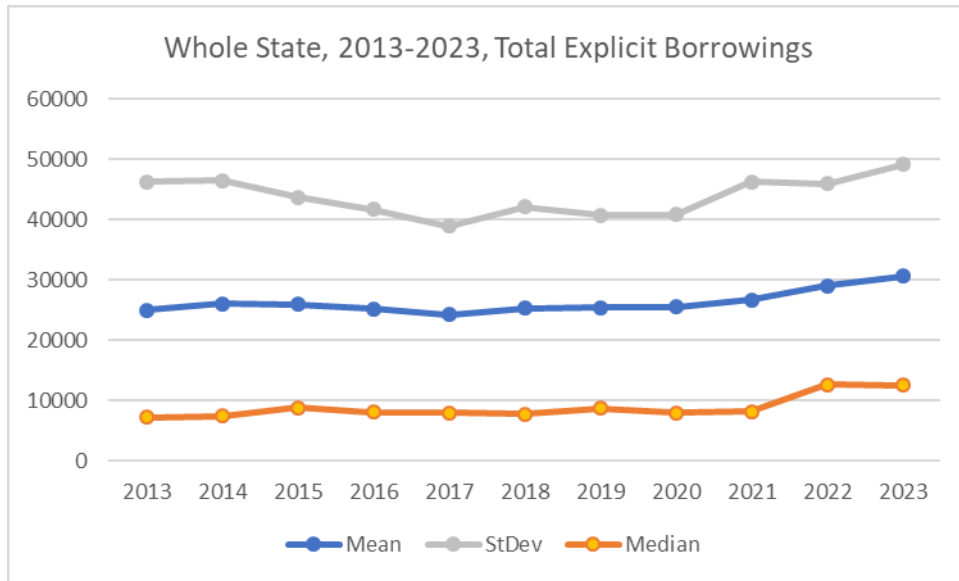
Figure 12



Professor Drew has also examined the changes to total explicit borrowings [his video on this topic can be found at <https://www.youtube.com/watch?v=SnMJAmJYHrs>]. It is important to note that this data refers to explicit borrowings only and not the much more worrying implicit debts carried by NSW local governments (Drew 2022). Implicit liabilities, such as neglected road sealing, are much more worrying because the debt is likely to be far greater than the value of the maintenance foregone. For example, if roads are not resealed on time, and the whole structure consequently needs to be dug-up and re-laid, then the cost is approximately eight times larger than it would have been had matters been dealt with in a timely fashion. Moreover, the data relating to implicit debts is significantly subject to distortion, which means we can only guess at the extent of the ticking time bomb.

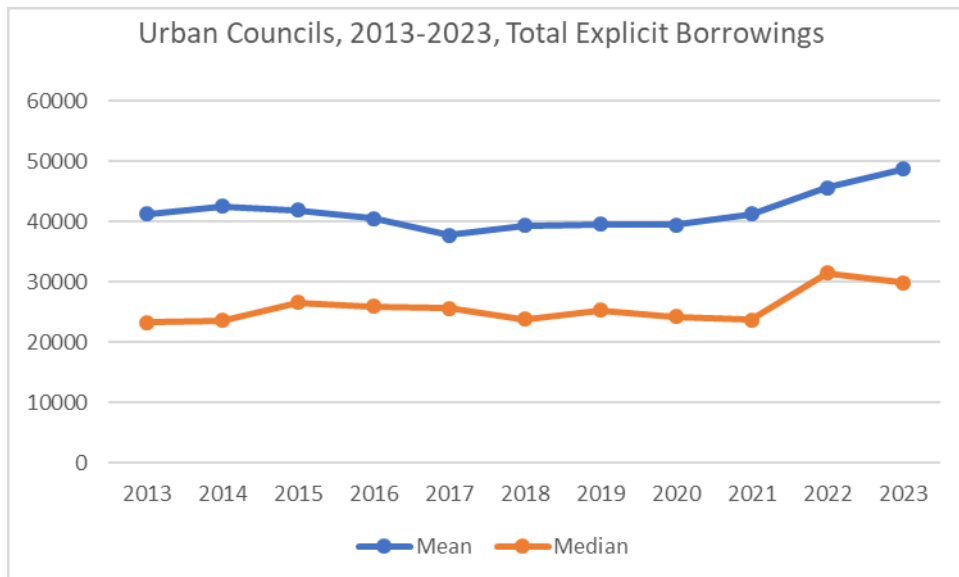
Figure 13 illustrates key measures of central tendency and spread for the whole state with respect to total explicit borrowings (which is the sum of current and non-current liabilities as per the audited financial statements). We would expect this figure to grow slightly over time in line with the time value of money. What is concerning is the sudden uptick in explicit liabilities in the last few years which echoes much of the data that we have already presented.

Figure 13



In Figure 14, it is noteworthy that the uptick is more pronounced for urban councils. Some of this is to fund new infrastructure to accommodate population growth consequent upon immigration, whereas other debt is more a reflection of stimulus efforts in the wake of COVID-19.

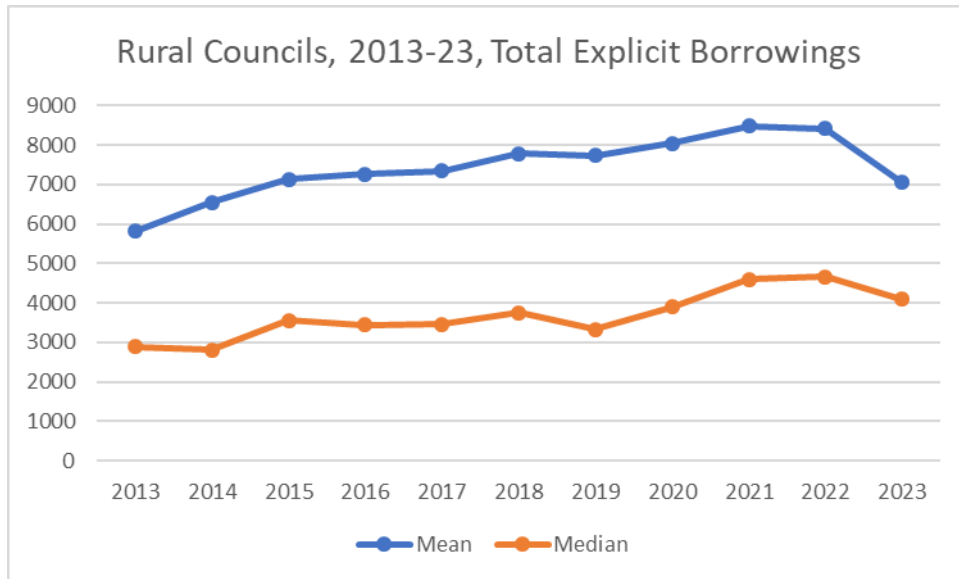
Figure 14



In Figure 15, explicit debt levels at rural councils are much lower, which reflects the debt aversion that is typical in rural areas. Debt aversion is not necessarily bad since it can lessen

the risk of intergenerational inequity. As Drew (2022) argues, significant scaffolding is required for the morally licit use of debt. There is a pronounced moral hazard associated with taking out debt for the next generation to repay, especially given the political attractiveness of this option over other policy options, such as increasing rates or fees. It is also interesting to note that rural councils seem to have put far more effort into paying down the face value of their debt, relative to their urban peers.

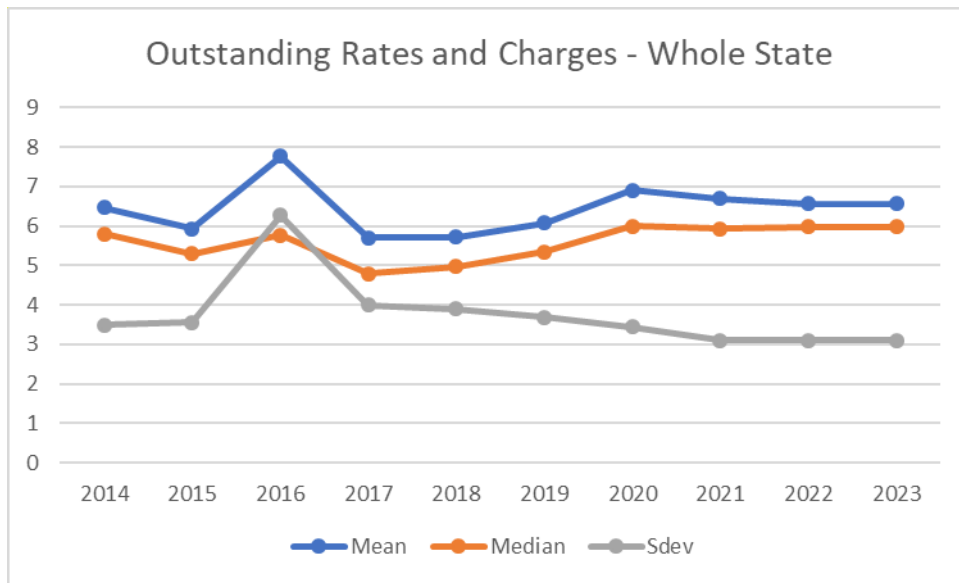
Figure 15



There is no single remedy to alarming declines in financial sustainability of the kind found in contemporary NSW local government, but certainly increases to taxation must be considered. [Professor Drew investigates ten years of outstanding rates and fees data in his video available at <https://www.youtube.com/watch?v= mt9PjOg5CY>].

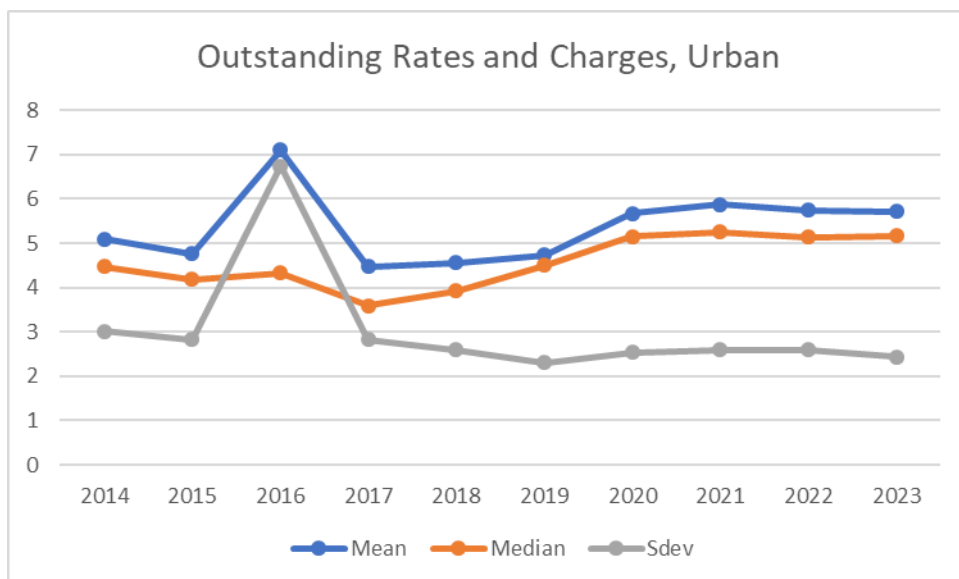
Despite much ado about the cost-of-living crises and complaints at every SRV round, the data which closely reflects capacity to pay tells a somewhat different story (Figure 16). Outstanding rates and charges did increase in the wake of the COVID-19 interventions, but probably far less than most might expect. Moreover, average percentages of outstanding revenues have been decreasing marginally since that time. We also need to be mindful that not all councils exert the same efforts in recovering revenues that they are owed, with some clearly more effective than others.

Figure 16



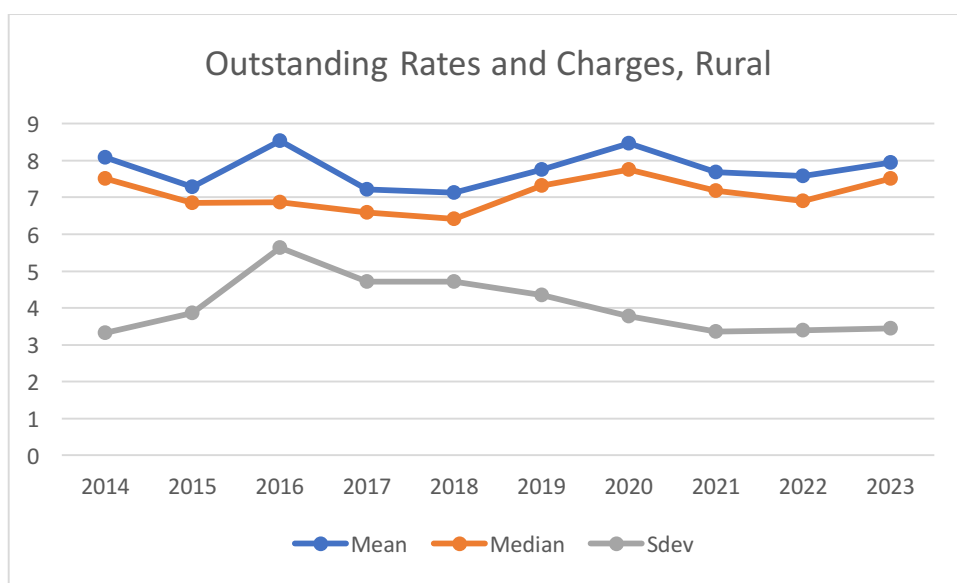
Outstanding rates and charges are considerably lower for urban councils (Figure 17), relative to their rural peers. This is in line with the findings of scholarly work which has shown that the revenue effort practiced by urban councils is considerably lower; that is, on the whole, urban councils extract a much lower proportion of the incomes accruing to residents than rural councils (Drew and Dollery 2017).

Figure 17



In Figure 18, we see this starkly when the rural data is stratified. In addition, to a considerable disparity in revenue effort, rural councils also tend to be more subject to economic shocks, especially fluctuations in the prices of commodities and adverse weather. Moreover, they often encompass land of little economic value (so-called ‘bush blocks’), where the cost benefit of paying land taxation may be significantly different to what it is in towns or cities. In sum, there may be scope to increase rates and charges in urban areas, but relatively less scope to do so in rural areas.

Figure 18



As we noted at the outset of this section of our discussion on financial sustainability in NSW local government, we have presented only a small subset of the data required to get a comprehensive picture of financial sustainability. However, the empirical material we have employed certainly gives solid cause for concern and underlines the importance of funding robust scholarly work to (a) empirically quantify our present financial sustainability situation, (b) monitor financial sustainability over time, and (c) use the data derived from these exercises to suggest evidence-based policy solutions.

An alternative perspective on the parlous state of financial sustainability in contemporary NSW local government can be gathered from the number of local councils that have sought Special Rate Variations (SRVs) in recent years in order to remain financially viable. Table 1 summarises the SRV approvals for the 2023/24 fiscal year:

Table 1: 2023/24 Special Rate Variation Approvals

Council	Amount	Purpose
Armidale	58.8% over 3 years	
Bega Valley	48.3% over 2 years	
Bellingen Shire	31.06% over 4 years	
Canada Bay	32.53% over 4 years	
Federation Council	39.2% over 2 years	Partial approval only
Hornsby Shire	31.05% over 4 years	
Junee Shire	32.19% over 2 years	
Lithgow	45.78% over 1 year	
Liverpool Plains	18.1% over 1 year	
Port Stephens	31.29% over 3 years	
Queanbeyan- Palerang	64.3% over 3 years	
Snowy Monaro	52.48% over 4 years	
Strathfield	92.83 over 4 years	
Tenterfield	43% over 1 year	Partial approval only
Tweed Shire	6.35% over 1 year	
Walcha Council	57.74% over 3 years	
Woollahra	22.23% over 2 years	

Source: Professor Joseph Drew (2023)

The financial plight of local councils forcibly amalgamated under the 2016 compulsory municipal merger program is illustrated in Table 2 showing the SRVs granted to compulsorily consolidated councils following the lifting of the rate freeze in the aftermath of the amalgamation program.

Table 2: SRVs for Amalgamated Councils since Rate Freeze Lifted

Local Government	Tax Increase Approved	Year Applied
Armidale	58.8% over 3 years	2023-24
Federation	39.2% over 2 years (temporary only approved; permanent 75% rejected)	2023-24
Snowy Monaro	52.48% over 4 years	2023-24
Central Coast	15% temporary for 7 years	2022-23
Snowy Valleys	35.95% over 2 years	2022-23
Armidale	10.5% over 1 year	2021-22
Canterbury-Bankstown	36.34% over 5 years	2021-22
Central Coast	15% temporary for 3 years	2021-22
Cootamundra-Gundagai	53.5% over 4 years	2021-22
Federation	8% over 1 year	2021-22
Georges River	32.6% over 5 years	2021-22

Source: Professor Joseph Drew (2023)

Taken together, the information on SRVs in Table 1 and Table 2 is striking in at least two respects. Firstly, the extent of property tax increases approved far exceeds earlier rate increases granted in SRVs, with the Queanbeyan-Palerang increase at 64.3% and the Armidale increase at 58.8% setting new records! Similarly, the sheer number of SRVs is exceptional. These features of recent SRVs serve to illustrate the acute financial sustainability problems in contemporary NSW local government.

Cost Shifting in Local Government

In *Australian Local Government Economics*, Dollery, Crase and Johnson (2006, p. 238/9) contend that cost shifting in the Australian municipal milieu has four broad components:

- (a) Grant Funding: Local government grants from federal and state governments have fallen in real terms. Moreover, ‘this is compounded by the fact that grants have failed to keep pace with changing responsibilities’.
- (b) Service Gaps: Local government has had to fill ‘the gap left by state and federal governments either withdrawing services or their failure to implement/provide services required by the community’. Furthermore, ‘local government has been required to “pick-up” services as a result of the direct transfer of “ownership” of infrastructure from another sphere of government’, such as aged care facilities in NSW.
- (c) Agency Fees: Fees imposed by higher levels of government have increased as ‘state and Commonwealth agencies have sought to recover a range of costs by increasing fees, license contributions and other charges imposed on councils’.
- (d) Legislative Requirements: Australian local councils have faced ‘major increases in accountability and compliance requirements without adequate recognition of the attending costs’. In addition, ‘legislation has required councils to provide concessions and rebates, with no compensation payment’; ‘services have formally referred to, and/or have been assigned to local government through legislative and other state and/or federal instruments, without corresponding funding’; local councils have been required to be ‘the sole provider of essential/important local services’; new services that ‘have no historical funding precedent have been mandated’; and fees and charges that ‘local government is permitted to apply, for services prescribed under state legislation or regulation, have little if any correlation to the cost of providing the service’.

Given the complexities of defining and measuring the impact of cost shifting on local government, in practice the optimal method of approaching the problem considers specific and incontrovertible examples of cost shifting that are amenable to measurement and are not beset by definitional problems or a blurring of responsibility between the different levels of government. It is thus difficult to derive aggregate estimates of cost shifting.

Nevertheless, an important case of this kind is the spatial impact of the provision of pensioner rate concessions by local authorities in NSW under the *Local Government Act 1993*. In terms of this legislation, a person meeting the definition of an eligible pensioner can claim various rebates on the rateable charges levied on their principal place of abode.

These rebates are constant across NSW local government jurisdictions, regardless of the differential ability to pay of both beneficiaries and local councils. Dollery, Johnson and Byrnes (2008) examined the uneven spatial impact of this form of cost shifting on different NSW councils with different fiscal capacities and different demographic characteristics.

Dollery, Johnson and Byrnes (2008) found that substantial differences existed between different categories of local government. In general, the burden of the NSW pensioner rate concession fell most acutely on municipal jurisdictions with the lowest ability to meet this impost in terms of both average earnings and rateable capacity. Moreover, although the NSW Local Government Grants Commission takes into account the financial circumstances of individual councils in its grant calculations, severe constraints on the magnitude of actual grants paid to councils means that grant compensation for rate concessions falls far short of their real cost.

Dollery, Johnson and Byrnes (2008) argued that, for designated recipients of pensioner rebates who are not in fact able to pay their full rates bill, other possibilities existed apart from the present NSW council-administered and part-funded pensioner rate concession. Firstly, the standard theory of fiscal federalism prescribes that the central government should carry out macroeconomic redistributive measures, not lower tiers of government (Oates 1972). This prescription is already embodied in most Australian income redistribution programs, like unemployment benefits and the age pension. Accordingly, the Commonwealth government should thus assume responsibility for pensioner rate concession programs, and not the present combination of state and local government, as in NSW.

A second alternative approach derives from the presumption that pensioner rate concessions are regressive. Following this assumption, it can be argued that the eligible categories of pensioner in NSW should fund their own rate concessions through the capital gain they may reap on the sale of their homes. Put differently, they could deduct the amount of the rate concession they received during the ownership of their residence from the capital gain accrued on the disposal of their residence, either upon their death or their transfer to another location. This is generally referred to as a 'reverse mortgage'. Under this funding arrangement, a pensioner would be loaned money on the argument that while they may be 'income poor', they may simultaneously be 'asset rich'.

Recent examples of new cost shifting devices include the move to centralised auditing, the mandatory establishment of Audit Risk and Improvement Committees (ARIC), the efforts to include the Red Fleet on local government books for accounting accrual purposes, and the fiscal stimulus programs during COVID.

Firstly, the centralisation of the auditing functions was supposed to improve the delivery of the service, including consistency in reporting. However, it also increased audit costs considerably, which in many councils more than doubled (McQuestin *et al.* 2021). It is ironic that some councils still have precisely the same auditor doing the work that they had prior to centralisation, largely because the Auditor-General's office outsources much of the activity. In addition, the speed of auditing has slowed tremendously. For instance, as mentioned, as at the end of March 2024, there were still some dozen councils that did not have audited financial statements publicly available for the period ended 30 June 2023. We note that s428 of the Act (NSW) requires audited financial statements to be available by the end of November each year. We cannot recall a time since the advent of centralised auditing when this requirement has indeed been universally satisfied.

Furthermore, the quality of the central auditing is questionable. For instance, the Auditor-General failed to discover the substantial problems at Central Coast Council in three successive audits. In addition, the notes of financial statements often miss important information. Furthermore, the efforts to bring greater consistency to depreciation accrual practice may have gone too far, and now likely run counter to the intent of Australian Accounting Standard 116 (McQuestin *et al.* 2021; Drew 2022). We are also aware of serious complaints against the Auditor-General (including what appears to be a legitimate dispute raised by Cessnock Council). Moreover, the financial sustainability report produced by the Auditor-General's office employs flawed metrics. It thus has much potential to distort decision-making, in addition to adding little value. In sum, fees for auditing have increased substantially whereas the quality of the work has declined alarmingly, putting the financial sustainability of the sector at greater risk.

Secondly, the Red Fleet, introduced by the Auditor-General's office, is a vexed issue. We agree with various missives by LG Solutions, and the remarks made by various Councils, as well as Professor Drew, that the Auditor-General is in error on this matter. The Australian Accounting Standards are quite clear; local governments do not possess unfettered control over these assets. It is thus wrong to require councils to account for the

assets on their consolidated statements. Doing so effectively transfers additional expenses onto councils.

Thirdly, the mandatory ARIC Committees are another bone of contention. We have worked with many councils where the ARIC committee has failed to perceive serious financial sustainability predicaments, or failed to offer useful advice to senior decision-makers to improve matters. We cannot see how most ARIC committees add value to the existing audit process governed by the Australian Auditing Standards. However, they do add considerable cost. Moreover, it is not simply the direct pecuniary costs, but significant indirect costs for staff to produce reports, attend meetings and chase down various rabbit holes (that distract them from more important tasks). We are yet to meet an ARIC committee that justifies this diversion of scarce resources.

Finally, fiscal stimulus during COVID could also be seen as an example of cost shifting. State and federal governments promoted stimulus programs for which they largely took the credit. Grants were then provided for work that invariably cost more to deliver than the funds granted. Local governments in most cases were required to fund the gap.

(d) Assess the social and economic impacts of the rate peg in New South Wales for ratepayers, councils and council staff over the past 20 years and compare with other jurisdictions.

Three major empirical studies have examined the impact of rate-capping in the Australian local government context. Firstly, Drew and Dollery (2015a) examined rate-capped NSW local government relative to (then) uncapped Victorian councils in order to determine the likely impact of a proposed rate-pegging regime on Victorian local government. Three dimensions of municipal performance were compared. Firstly, Drew and Dollery (2015a) tested inter-municipal revenue effort equity by assessing residential tax effort. Residential tax effort measures the proportion of residential rates paid as a percentage of the total annual incomes accruing to residents in a given local government area. Drew and Dollery (2015a) found that rate-capping in NSW had reduced inter-municipal equity, possibly because of the compounding effects of a rate-cap where initial residential tax effort differed between councils.

Secondly, Drew and Dollery (2015a) investigated the impact of rate-capping on financial sustainability by considering local government liabilities per household for NSW and Victorian councils over the period 2009/2013. They found that NSW had much higher

levels of council debt per household. They also examined the average infrastructure renewal ratio in NSW and Victoria as a measure of the infrastructure backlog and established that NSW had a substantially larger local infrastructure backlog.

Finally, Drew and Dollery (2015a) tested the claim that rate-pegging obliged councils to become more efficient. In fact, using data envelopment analysis (DEA) to examine the relationship between inputs and outputs, Drew and Dollery (2015a, p. 145) found empirical evidence indicating a 'slightly higher average municipal efficiency for Victorian councils'.

Following the methodology employed by Drew and Dollery (2015a), Dollery and McQuestin (2017) empirically examined the likely impact of the imposition of a rate-cap in South Australian (SA) local government by comparing the performance of SA local government with its NSW counterpart on three separate key measures (revenue effort, financial sustainability and efficiency) for the period 2013 to 2016. Dollery and McQuestin (2017, p.84) established that for revenue effort 'the results from our stratified sample show that rate-capping in NSW has not served to reduce inter-municipal revenue effort inequities'. Moreover, rate-pegging is thus 'most unlikely to minimise these inequities in SA local government'. Secondly, they found that the 'claims made by advocates of rate-pegging that it improves financial sustainability are rebutted by our findings'. Using council debt per capita as a proxy for financial sustainability, Dollery and McQuestin (2017) demonstrated that 'NSW local authorities have much higher debt than their SA counterparts despite the four decade long rate-pegging regime in NSW'. Dollery and McQuestin (2017, p.84) further found that the operational efficiency of councils did not improve under rate-capping. Employing municipal expenditure per capita as a measure of the operational efficiency of local authorities, Dollery and McQuestin (2017, p.84) demonstrated that 'rate-pegging does not increase the efficiency of local councils: for each year in our sample, the efficiency of NSW councils falls well below SA councils'.

Dollery and McQuestin (2017, p.84) concluded that 'on all three dimensions of local government examined in our empirical analysis, we find SA councils performed better than NSW local government notwithstanding the latter's longstanding rate-pegging policy'. Given these findings, Dollery and McQuestin (2017, p.84) determined that 'the empirical evidence presented in the paper demonstrates that rate-pegging should not be

imposed on SA local government and instead other more promising policies [should be] considered’.

Finally, Yarram, Tran and Dollery (2021) employed expenditure data covering the period 2014/15 to 2017/18 to investigate empirically the short-term impacts of rate-capping on municipal expenditure in the Victorian local government system to determine whether it had differential effects on expenditure in different types of local authority. Yarram, Tran and Dollery (2021, p.11) found that ‘it is clear that the impact of rate-capping varies between urban and rural councils’. Moreover, ‘rural councils that generally rely more on rates are unsurprisingly unable to incur higher expenditure following a rate-capping’. This contrasts with urban councils ‘that are able to increase total expenditure, perhaps through other sources of funding’. In addition, with respect to the impact of rate-capping on different kinds of municipal expenditure, Yarram, Tran and Dollery (2021, p.11) found that ‘rate-capping reduces outlays, especially on aged and disabled services, in both rural and urban councils’. Furthermore, they established that ‘there is a reduction in expenditure on family and community services in urban councils’.

Yarram, Tran and Dollery (2021, p.17) concluded their paper by placing it in the context of the earlier empirical analyses of the impact of rate-pegging on Australian local government. They noted that ‘the findings of this study are broadly consistent with the previous results of Drew and Dollery (2015) who found that rate-capping in NSW made its local councils more constrained compared to councils in Victoria before the rate-capping’. In addition, they observed that ‘our findings are also consistent with Dollery and McQuestin (2017) who established that NSW councils under a rate-capping regime suffered in terms of unsustainable financing and lower operational efficiency compared to councils in SA, which did not have any rate limitations’.

In addition to this scholarly literature, in a report entitled *Rate-pegging in NSW Local Government: An Analysis of the Empirical Evidence*, Dollery (2022) considered the major arguments in the ongoing debate in NSW local government over the impact of rate-capping, theoretical considerations on the nature of property tax limitations and their regulation, the international empirical literature on the impact of property tax limitations, the empirical literature on the impact of rate-capping in Australian local government, as well as the findings of recent inquiries and official reports on rate-pegging in NSW local government. Dollery (2022) argued that ‘it is clear that the existing rate-capping regime

in NSW local government has had deleterious effects on municipal performance, especially the continuing inadequacy of revenue from rates, related ongoing problems with the financial sustainability of NSW local government and associated insufficient infrastructure maintenance and renewal’.

Given these problems, Dollery (2022) proposed two ‘alternative approaches to improving the NSW local government rating system’. Firstly, Dollery (2022) argued that a ‘first-best’ approach would be for the NSW Government to simply abolish rate-pegging and thereby give local authorities the latitude to strike their own rates and be held accountable by their own local residents. This approach would accord with both economic theory on optimal municipal property taxation and the weight of international and Australian empirical evidence on property tax limitations.

Secondly, Dollery (2022) proposed an ‘alternative “second-best” approach would recognise the realities of political barriers in NSW to the abolition of rate-capping and instead focus on removing the worst features of the rate-pegging regime’. This would contain three main elements: (a) a rate-peg would be set for a minimum of three years in advance to facilitate financial planning by local councils; (b) the process of determining the rate-cap would be modified to include input from a panel of local government experts as well as a more accurate method of determining cost escalations in NSW local government than the current misconceived IPART methodology; and (c) the process of applying for SRVs should be eased further to automatically grant SRVs unless there are compelling grounds to the contrary.

(e) Compare the rate peg as it currently exists to alternative approaches with regards to the outcomes for ratepayers, councils and council staff.

Under (d) above, we briefly outlined the peer-reviewed research on the impact of rate-pegging in Australian local government. As we have seen, three main empirical papers have investigated the effects of rate-capping in Australian local government. Without exception, all three studies found that property tax limitations in the form of rate-pegging had deleterious effects across those state local government systems in which they had been imposed. For example, as we have seen, in their study of the NSW local government compared to the (then) uncapped Victorian local government system, Drew and Dollery (2015a) found that NSW local councils had suffered from three main problems:

(a) NSW local government had reduced inter-municipal equity, possibly because of the compounding effects of a rate-cap where initial residential tax effort differed between councils.

(b) NSW local councils had much higher levels of council debt per household and a substantially larger local infrastructure backlog.

(c) Victorian councils had a 'slightly higher average municipal efficiency' than their NSW counterparts.

Similarly, as related earlier, in their comparison of the uncapped SA local government system with its NSW counterpart on three separate key measures, Dollery and McQuestin (2017) examined revenue effort, financial sustainability and efficiency over the period 2013 to 2016. They established that NSW local government fared badly by comparison with SA local government in three respects:

(a) In terms of revenue effort, rate-capping had failed to reduce inter-municipal revenue effort inequities in NSW local government.

(b) Using council debt per capita as a proxy for financial sustainability, Dollery and McQuestin (2017) found that NSW local councils had 'much higher debt than their SA counterparts' despite the four decade long rate-pegging regime in NSW.

(c) The operational efficiency of councils did not improve under rate-capping; the efficiency of NSW councils was in fact well below the efficiency of SA councils.

Finally, as noted, Yarram, Tran and Dollery (2021) examined whether rate-capping in the Victorian local government system had had differential effects on expenditure by different types of local council. They found that rate-pegging affected rural councils more than their urban counterparts because rural councils generally relied more on rates rather than other types of own-source revenue. By contrast, urban councils could use other sources of funds, like fees and charges, to offset rate-capping restrictions on income.

In sum, while further research into the impact of rate-capping on Australian state and territory local government systems is required, the three extant studies are unanimous in concluding that rate-pegging has deleterious effects on local councils and their local communities. This is especially evident in terms of municipal debt levels and infrastructure backlogs. Moreover, rate-capping discriminates against rural councils whose socio-economic characteristics mean they are more heavily dependent on rates as an own-source income.

(f) Review the operation of the Special Rate Variation process and its effectiveness in providing the level of income councils require to meet the needs of their communities.

The SRV process in NSW local government has several positive characteristics. It employs sound criteria in its assessments of the financial viability of local councils. Moreover, when a local council prepares a SRV submission in a thorough manner, this typically provides a useful ‘reality check’ for its councillors and senior management on its financial circumstances.

However, the SRV process in NSW can be improved in at least five ways. Firstly, the composition of the rate-cap determination panel, together with the SRV assessment panel, should include at least one scholarly local government expert. Familiarity with property tax limitation theory and sophisticated empirical techniques is vital for the determination of a sound cap. Moreover, scholars enjoy greater independence and can bring fresh insights. Many of the problems associated with recent changes to the IPART rate-cap methodology may not have occurred if an informed scholar had been on the deliberative panels.

Secondly, IPART must achieve a much faster turnaround period in its SRV assessment process. In many cases, earlier notification of SRV application outcomes can provide valuable information to local councils that are experiencing severe financial difficulties, thereby enabling them to take remedial action in a timely manner.

Thirdly, it is important that IPART establish sensible timelines for SRV nomination dates and applications. At present, the current timeline for SRVs could hardly be worse. As Table 3 illustrates, it contributes to a range of avoidable costs. In practice, this often means that local councils are breaking ‘bad news’ to their local communities immediately prior to Christmas. In the most recent year of delayed elections, the early nomination date meant that many councils delayed their SRV application by an additional year. This may well have caused serious financial sustainability problems. Moreover, the current timeline increases stress on council staff who often have to give up customary extended periods of leave taken over the festive season. Furthermore, it adds to any consultant costs because consulting companies are often obliged to pay premiums to their staff to work during the festive season.

By contrast, in the Victorian local government system sensible dates apply, as Table 3 shows. Notification of intent to apply is purely optional, as it should be. Furthermore, the applications can be submitted over a long period that allows for much better assessment

turnaround times. Furthermore, it is likely that applications are assessed on their own merits rather than being sub-consciously compared with other applications.

Table 3: Special Rate Variation Key Dates for NSW and Victoria in 2022

Event	NSW Date	Victorian Date	Recommendation
Notification of Intent to apply for a SRV	26 November	31 January*	End of January (optional)
SRV application due date	7 February	1 February until 31 March	Should be submitted any time prior to mid-April
Determinations announced	May 2022	Within two months of receiving the application	Within six weeks of application

* Note this is only an option in Victoria. It is not mandatory to give notice of intent.

Fourth, we recommend that ‘automatic triggers’ should be employed for SRVs. A significant problem with the current NSW rate-peg regime is that it has high political costs. This explains why many local councils are hesitant to indicate intent to apply for an SRV in election years. The problem with delaying SRVs is that a council may fail financially in the interim. Moreover, it may mean that eventual increases need to be higher to compensate for foregone rate revenue for the year(s) deferred.

By contrast, political costs associated with local councils making SRV applications might be reduced by making SRV applications mandatory when certain triggers are met. This would signal to the local community in question that the SRV is required by fiscal prudence rather than by political choice. It would also mean that the rate-cap regime would not add further to the appalling record of local government financial failure in the NSW local government system (Drew 2022).

Any financial triggers should contain standard ratios already in use. However, they would require the NSW Office of Local Government (OLG) to employ reasonable benchmarks based on empirical evidence (rather than the current apparently arbitrary numbers). In

particular, the following ratios are suggested: Operating ratio (over three years), unrestricted current ratio (with a more suitable benchmark), debt ratio (with a more appropriate benchmark), cash expense ratio (using a more appropriate benchmark) and rates outstanding (currently there is no benchmark and a ceiling, rather than a floor, would be best to protect ratepayers).

Note that we have specifically excluded asset maintenance ratios because they are typically too unreliable at present. Moreover, their use may exacerbate the already high levels of distortion in these numbers.

Given that SRV applications are publicly available (and should be based on evidence of need according to prescribed criteria), the burden of proof should rest with the SRV assessment panel or those who object to the proposal to provide compelling reasons as to why an SRV should be rejected or reduced. This is particularly the case when local councils have drawn on suitably qualified experts to assist in the preparation of the SRV and where they have provided robust empirical evidence in support of their claims. In sum, reversing the burden of proof along these lines would more appropriately respect the efforts of council staff and the deliberations of politically accountable councillors.

(g) Any other related matters

Structural Impediments to Security for Local Government Workers and in Infrastructure and Service Delivery.

In common with all employers, local government has had to adapt to significant changes over the past four decades, with some based on legislation and others based on ideology. However, the extent and nature of change has differed across the different Australian local government systems. For instance, local government in NSW has not faced the degree of corporatisation and privatisation evident in other local government jurisdictions and other tiers of government in the Australian federation. In many cases, local services have simply been privatised or contracted out. This has seen an emphasis on profit maximisation and cost minimisation over service delivery and employment conditions and job security.

NSW local government has largely escaped corporatisation and privatisation due to vigorous action by local government unions. In particular, ongoing action by the Municipal Employees Union (MEU), which in 2003 became the United Services Union (USU), has

been effective. The USU currently has approximately 30,000 members drawn from NSW local government employees, who total around 50,000 workers.

The Local Government Association in NSW (LGNSW) has also been active. It has generally worked pragmatically and cooperatively with the USU and other industry unions in modernising the NSW Local Government Award. The NSW Local Government Award now combines over half a dozen pre-1992 NSW Local Government Industry Awards in a single Award, which is based on flexibility, innovation and skills. The Award has a skills-based salary system instead of the previous prescriptive awards that did not encourage or recognise flexibility or multi-skilling. This new modernised Award first came into being on the 8th June 1992 as a consent Award, achieved by negotiation and cooperation rather than by conflict and industrial action.

The practice of renegotiating each new Award as the previous consent Awards were due to expire has seen successive NSW Local Government Industry consent Awards re-negotiated in 1995, 1997, 2000, 2001, 2004, 2007, 2010, 2014, 2017, 2020 and 2023. The current Award commenced on the 1st July 2023 and runs until the 30th June 2026. A new re-negotiated Award will come into effect from the 1st July 2026 for the maximum permissible 3-year period allowed under current NSW Industrial Relations legislation.

The NSW Local Government Award represents best practice in Australian local government. For example, clause 2 serves to demonstrate the efficacious nature of the NSW Local Government Award. Clause 2 ‘Statement of Intent’ states the following:

‘The parties to the Award are committed to co-operating positively to increase the productivity, structural efficiency and financial sustainability of Local Government and to provide employees with access to more fulfilling, varied and better paid work by providing measures to for instance:

- Improve skill levels and establish skill-related career paths;
- Eliminate impediments to multi skilling;
- Broaden the range of tasks which a worker may be required to perform;
- Achieve greater flexibility in workplace practices;
- Eliminate discrimination;
- Establish rates of pay and conditions that are fair and equitable;
- Work reasonable hours;

- Promote job security;
- Ensure and facilitate flexibility for work and family responsibilities;
- Ensure the delivery of quality services to the community and continuous change;
- Encourage innovation;
- Promote cooperative and open change management processes; and
- Promote the health and safety of workers and other people in the workplace’.

In common with many other clauses in the NSW Local Government Award, Clause 2 demonstrates the pragmatism and positive working relationship between the Award parties. These positive features have existed for more than three decades of negotiating industry consent Awards. They demonstrate that the various parties have worked together to improve the NSW local government industry.

The NSW industry Award parties also negotiated an Industry COVID-19 Splinter Award early during the COVID restrictions period. It was renewed annually for 3 years until no longer required. It served to provide certainty and employment protection for municipal employees in NSW during the COVID period. This was crucial at the time since the (then) Australian Government funding to protect workers impacted by COVID did not cover local government employees.

The NSW COVID-19 Splinter Award was better than any other industry-negotiated protections during the Covid-19 restrictions period. It saw the parties agree to waive certain Award conditions regarding work locations and work duties to provide meaningful access to work to ensure essential local services continued to operate during lockdowns and restricted travel periods.

In essence, the NSW Local Government Award is far superior to the Federal Modern Award equivalent that only generally applies to local government in those state systems that surrendered their state industrial responsibilities to the Australian Government in the past.

The NSW Local Government State Awards are generally negotiated for a 3-year period. Each new Award seeks to include changes required to enhance efficiency, as well as to meet the needs of both the workers and the employers. The Award also provides both the employers and employees with 3 years of certainty regarding annual Award salary

increases. Pay increases occur in the first pay period in July each year. This facilitates local council budgeting and forward planning for each financial year.

As a result, NSW councils and their employees know what their salary increases and their wage costs will be up to 3 years in advance. This provides a degree of financial certainty for both parties. This contrasts with what workers in the Federal Award must endure, who must wait each year for the annual Fair Pay Commission decision.

In contrast to the certainty over annual staff salary increases enjoyed by NSW local councils, they face annual uncertainty regarding what their rate-peg will be for the next financial year. This is only revealed a few months prior to the forthcoming financial year, severely limiting the required time to finalise their annual budgets.

Similarly, NSW Government road funding is also generally only announced to NSW councils annually, as well as any increases in NSW Government levies imposed on NSW councils, such as the Waste Levy for example. In addition, Australian Government financial transfers to local councils, such as Financial Assistance Grants (FAGs) grants, are also allocated annually and without any clear commitment as to what the next financial year or successive years' funding allocation will be.

This practice of only committing and confirming state and federal funding on an annual basis inevitably generates problems. For instance, local councils must often make inaccurate assumptions in their forward planning and budgeting.

This financial uncertainty occurs simultaneously with significant cost shifting onto local government. As a result, local councils must frequently undertake to maintain or provide local services to their local communities previously provided by state and/or federal governments. This has a significant negative financial impact on many local councils, especially in regional, rural and remote areas. Indeed, it is not uncommon to see twenty percent or more of a council's annual budget expended on providing or maintaining services due to cost shifting. In this regard, the NSW Upper House has recently announced an inquiry into council funding, which includes in its terms of reference rate-pegging, cost shifting and funding in general.

In addition, many local councils are also faced with significant numbers of migrants and others relocating to their local government areas. This places significant strain on existing local services and infrastructure, much of which is ageing and in need of maintenance and

repairs. It also necessitates the construction of new infrastructure. Moreover, problems arise from the continuing cost of ongoing maintenance and of staffing costs for new infrastructure funded by one-off grants to build the new infrastructure, but with no ongoing necessary funding provided to maintain and staff new infrastructure.

As we have seen, the FAG process is problematic, especially since the percentage GDP allocated to these grants has experienced significant reductions and fluctuations over the past three decades. During the Hawke/Keating Government period, FAG grants exceeded 1% of GDP, at times reaching as high as 1.3%. However, under successive governments they have fallen to 0.33% of GDP under the Abbot Government and then risen to 0.55% of GDP under the Morrison Government. There is industry consensus in the local government sector, including unions and employer associations, that FAG grants must be increased to a minimum at least 1% of GDP.

In all Australian local government systems, local councils have a limited capacity to raise their own funds, especially in NSW and Victoria, where they operate under rate-pegging. However, even the abolition of rate-pegging would not make many local councils financially sustainable. For example, many local councils in regional, rural or remote areas have neither the population nor rate base to generate sufficient funding for essential local services, new infrastructure and adequate staffing. As we have seen, this has led *inter alia* to a massive local infrastructure backlog across all Australian local government systems.

In NSW local government, which suffers under a longstanding rate-pegging regime, there is ongoing discontent about the decision-making process of IPART. For example, IPART regularly approves significantly higher increased fees and charges to state-owned corporations, such as Sydney Water and Hunter Water, which possess massive capacity and scale compared to NSW council operated water and wastewater services. In 2023, for instance, IPART approved 7% increases in charges for Sydney Water and Hunter Water. This increase was almost double the rate-peg limit of 3.7% that financial year for over a hundred NSW councils providing the same water and wastewater services to their local communities. These councils not only had much lower populations and fewer paying consumers, but also provided infrastructure over much larger geographical areas, while inflation was running at double the rate-peg limit. This demonstrates *inter alia* that NSW councils, which provide water and wastewater services, must be substantially more efficient than the much larger state-owned corporate entities - Sydney Water and Hunter Water -

even factoring in the dividends paid by the state-owned corporations back to the NSW Government.

NSW Government owned, locally owned and run county councils/energy distributors represent a further example of the rationalisation and privatisation of public assets and services failing to deliver cheaper and more efficient services. In 1997, 27 NSW power distributors were forcibly amalgamated into four entities. This resulted in thousands of redundancies and a loss of local services and knowledge in many communities, thereby preparing the sector for privatisation. However, the net result did nothing to reduce costs, improve services, or even maintain the same level of services for the consumers. Instead, it provided the (then) future private owners with significantly reduced staffing levels and lower costs that assisted them in generating greater profits for shareholders rather than focusing on cheap, reliable access to energy provided by local service providers and the retention of local jobs.

To ensure the ongoing viability and financial security of local government adequate long-term state and federal funding, cost shifting and the ability of councils to decide local rates and local fees and charges must be addressed. Moreover, the current massive local infrastructure backlog must be tackled with sufficient funding.

References

- Allan Report (Independent Inquiry into the Financial Sustainability of NSW Local Government). (2006). *Are councils sustainable? Final report: Findings and recommendations*. Sydney, NSW: NSW Local Government and Shires Association.
- Bisogno M., Cuadrado-Ballesteros B. and García-Sánchez I.M. (2017), Financial sustainability in local governments: definition, measurement and determinants. In Bolívar M. P. R. (Ed.), *Financial Sustainability in Public Administration*, Springer, pp. 57-83.
- Commonwealth Grants Commission. (2001), *Review of the operation of Local Government (Financial Assistance) Act 1995*. Canberra: Commonwealth Grants Commission.
- Department of Transport and Regional Services. (2007). *2005/06 local government national report*. Canberra, ACT: Department of Transport and Regional Services.
- Dollery, B. E. (2022), *Rate-pegging in NSW Local Government: An Analysis of the Empirical Evidence*, USU submission to the IPART Review of the Local Government Rating System: Final Response.
- Dollery, B. E., Crase, L. and Johnson, A. (2006), *Australian Local Government Economics*, Sydney, University of New South Wales Press.
- Dollery, B. and Drew, J. (2017). In Whose Interest? An Assessment of the New South Wales Government's Post-Amalgamation Rate Path Freeze Policy. *Journal of Australian Taxation*, 18: 143-162.
- Dollery, B. E., Grant, B. and Kortt, M. (2012), *Councils in Cooperation: Shared Services and Australian Local Government*, Sydney, Federation Press.
- Dollery, B. E. Johnson, A. and Byrnes, J. (2008), Cost Shifting in Australian Local Government: An Analysis of the Spatial Impact of Pensioner Rate Concession Rebates in New South Wales", *Australian Geographer*, 39(4), 467-478.
- Dollery B. E., Kitchen, H., McMillan, M. and Shah, A. (2020), *Local Public, Fiscal and Financial Governance: An International Perspective*, Palgrave McMillan New York.

Dollery, B. E., Kortt, M. and Grant, B. (2013), *Funding the Future: Financial Sustainability and Infrastructure Finance in Australian Local Government*, Sydney, Federation Press.

Dollery, B. E. and McQuestin, D. (2017), 'No Panacea: Rate-Capping in South Australian Local Government', *Economic Analysis and Policy*, 56(4), 79-85.

Dollery, B. E. and Tiley, I. (eds.) (2015), *Perspectives on Australian Local Government Reform*, Sydney: Federation Press.

Dollery, B. E., Wallis, J. and Akimov, A. (2010). One size does not fit all: The special case of remote small councils in outback Queensland. *Local Government Studies*, 36(1), 21-42.

Dollery, B. E., Wallis, J. L. and Allan, P. (2006). The debate that had to happen but never did: The changing role of Australian local government. *Australian Journal of Political Science*, 41(4), 553-567.

Drew, J. (2017). Playing for Keeps: Local Government Distortion of Depreciation Accruals in Response to High Stakes Public Policy-Making. *Public Money & Management*, 38(1): 57-64.

Drew, J. (2022), *Saving Local Government*, Springer Palgrave: Singapore.

Drew, J. (2024), *Capacity to Pay for Special Rate Variation: Report for Federation Council*.

Drew, J. and Dollery, B.E. (2015a). 'Careful what you wish for: Rate-capping in Victorian local government', *Journal of Australian Taxation*, 17 (1), 139–163.

Drew, J. and Dollery, B (2015b). A Fair Go? A Response to the Independent Local Government Review Panel's Assessment of Municipal Taxation in New South Wales. *Australian Tax Forum*, 30(3): 471-489.

Drew, J. and Grant, B. (2017). Means, Motive and Opportunity: Distortion of Public Policy Making Performance Management Data. *Australian Journal of Public Administration*, 75(1): 237-250.

Drew, J., McQuestin, D. and Dollery, B. E. (2021), 'Did Amalgamation Make Local Government More Fit for the Future? *Australian Journal of Public Administration*, 81(2): 383-398.

Drew, J. D., McQuestin, D. and Dollery, B. E. (2023), 'Fiscal Outcomes Arising from Amalgamation: More Complex than merely Economies of Scale', *Public Management Review* (in print).

Farvacque-Vitkovic C. D. and Kopanyim, M. (2014), *Municipal finances: A handbook for local governments*, World Bank: Washington, DC.

Hawker Report (House of Representatives Standing Committee on Economics, Finance and Public Administration) (2003), *Rates and taxes: A fair share for responsible local government*. Canberra, ACT: Commonwealth of Australia.

Johnson, A. (2003), 'Financing Local Government in Australia', in B.E. Dollery, N.A. Marshall and A.C. Worthington (Eds.), *Reshaping Australian Local Government: Finance, Governance and Reform*, pp.37-63, Sydney: UNSW Press.

McQuestin, D., Noguchi, M., and Drew, J. (2021). The Association Between Budget Inaccuracy and Technical Efficiency in Australian Local Government. *Public Money & Management*, DOI: 10.1080/09540962.2021.1893464.

Oates, W. E. (1972), *Fiscal Federalism*, Harcourt Brace Jovanovich, New York.

PriceWaterhouseCoopers (2006), *National financial sustainability study of local government*, Sydney, NSW: PriceWaterhouseCoopers.

Yarram, S., Tran, C. and Dollery, B. E. (2021), 'The Impact of Rate Capping on Local Government Expenditure', *Policy and Politics*, 49(3), 391-411.

Yarram, S.R, Tran, C. and Dollery, B. E. (2024), 'The Impact of Administrative Intensity on Financial Sustainability in Local Government: An Empirical Analysis of New South Wales', *Public Administration Quarterly*, 47(4): 456-476.

**A Critical Assessment
of the Rate Peg
Methodology in the
IPART (2023) *Review
of the Rate Peg
Methodology: Final
Report***

Contact:**Disclaimer**

This Report was prepared by Brian Dollery on behalf of New England Education and Research Proprietary Limited for the United Services Union (USU). This Report was produced for the USU as a strictly independent Report. The opinions expressed in the Report are thus exclusively the views of its author and do not necessarily coincide with the views of the USU or any other body. The information provided in this Report may be reproduced in whole or in part for media review, quotation in literature, or non-commercial purposes, subject to the inclusion of acknowledgement of the source and provided no commercial use or sale of the material occurs.

EXECUTIVE SUMMARY

IPART released its *Review of the Rate Peg Methodology: Final Report* in August 2023. The *Final Report* was prepared after submissions had been received from stakeholders across the sector, including the USU with its *Rate Capping in New South Wales Local Government: Addressing the Questions Raised in the IPART (2022) Review of the Rate Peg Methodology: Issues Paper and Further Recommendations for Further Improvement* (USU 2022).

The USU (2022) report dealt *inter alia* with two substantive matters:

- Firstly, section 8 of the USU report described the numerous problems with the IPART (2022) rate-pegging methodology.
- Secondly, section 10 concluded the USU report by offering two alternative generic recommendations for dealing with the manifold problems besetting the current NSW rate-pegging regime.

This report covers the following dimensions of the IPART rate peg methodology evolution:

- It briefly outlines the problems with the initial rate peg methodology in the (2022) *Review of the Rate Peg Methodology: Issues Paper*.
- It summarises the best methods of addressing these problems, as set out in our earlier *Rate Capping in New South Wales Local Government: Addressing the Questions Raised in the IPART (2022) Review of the Rate Peg Methodology: Issues Paper and Further Recommendations for Further Improvement* (USU, 2022).
- It provides a synoptic account of the subsequent changes made to the rate peg methodology IPART in its *Review of the Rate Peg Methodology: Final Report* (IPART, 2023).
- Finally, in its section 5 the report (a) offers an overall assessment of the changes made to the rate peg methodology in the *Final Report* and (b) offers five recommendations for tackling the remaining problems in rate peg methodology in the IPART (2023) *Final Report*:
 - (1) The continued use of RBA CPI data in the rate peg methodology in the *Final Report*.
 - (2) The use of three council categories based on NSW OLG data in the *Final Report*.
 - (3) The use of Award negotiation outcomes to adjust the rate peg in the *Final Report*.
 - (4) The continued use of a population factor to proxy council output instead of the number of property assessments.

(5) The need for IPART to specify a definitive method of how to use 'rounding' in calculating the rate cap.

1. Introduction

Our earlier report on the IPART (2022) *Review of the Rate Peg Methodology: Issues Paper*, entitled *Rate Capping in New South Wales Local Government: Addressing the Questions Raised in the IPART (2022) Review of the Rate Peg Methodology: Issues Paper and Further Recommendations for Further Improvement* (USU 2022) dealt *inter alia* with two substantive matters:

- Firstly, section 8 of our report described the numerous problems with the IPART (2022) rate-pegging methodology.
- Secondly, section 10 concluded our report by offering two alternative generic recommendations for dealing with the manifold problems besetting the current NSW rate-pegging regime.

The present report begins by briefly summarising these dimensions of our earlier report before critically examining the new IPART (2023) *Review of the Rate Peg Methodology: Final Report* released in August 2023.

2. Problems with the IPART (2022) Rate Peg Methodology

As we noted in our analysis of the IPART (2022) rate peg methodology, in its *Review of the Rate Peg to Include Population Growth: Final Report*, IPART (2021) delineated its new methodology and then applied it to each NSW local authority for the 2022/23 financial year in order to calculate the rate cap for each local government. The new formula incorporated a population factor that varied for each local council contingent on its population growth rate (IPART, 2021):

Rate peg = change in LGCI – productivity factor + other adjustments + population factor

The new formula deployed four independent variables as its foundation for computing the annual rate cap for each local council:

Change in LGCI comprises the annual change in the Local Government Cost Index (LGCI). The LGCI measures price changes over a given year for goods, materials and labour employed by an ‘average council’. Specifically, the LGCI computes the average change in prices of a fixed ‘basket’ of goods and services employed by local councils relative to the prices of the same basket in a base period. The LGCI has 26 cost components, encompassing

inter alia worker benefits and on-costs, together with building materials for bridges, footpaths and roads. These cost components embody the purchases made by an average local council to conduct its 'typical activities'. IPART uses ABS price indexes for wage costs, producer prices and consumer prices. In computing these price indexes, the ABS includes quality adjustments in its price measures to accommodate increases in capital and labour productivity.

- (a) *Productivity factor* is included in the formula since productivity increases offset changes in the LGCI. For instance, if labour productivity increases, the net price of labour will decrease by the degree of the productivity increase. However, because the ABS price index data has already been adjusted for productivity changes, in practice IPART sets the productivity factor at zero in the formula.
- (b) *Other adjustments* is included in the formula to accommodate any additional payments or transfers to local councils that may have happened. For example, in its 2022/23 rate peg computations IPART (2021, p.2) included a downward adjustment of 0.2% to eliminate the additional revenue that was included in the 2021-22 rate peg to meet the costs of the 2021 local government elections.
- (c) *Population factor* is calculated for each local government. The population factor is equal to the annual change in the estimated residential population adjusted for revenue derived from supplementary valuations. Specifically, the population factor equals the maximum change in the residential population less the supplementary valuations percentage or zero. Local councils with negative population growth receive a population factor of zero. This means that no local authority amasses a smaller increase in general income, relative to a rate peg calculated using the LGCI, a productivity factor or any adjustments. Those local councils that secured more from supplementary valuations than required to maintain per capita general income as their population increases will also have a population factor of zero. The population factor is calculated using the following formula: *Population factor* = $\max(0, \text{change in population} - \text{supplementary valuations percentage})$

The change in population is computed employing the *Estimated Residential Population* (ERP; emphasis added) published by the ABS.

IPART calculated the rate peg for the financial year 2022/23 employing the new formula with LGCI change, a population factor and an adjustment to remove the costs of the 2021 local government elections that were included in the 2021-22 rate peg. This produced a 2022/23 rate peg for each NSW local council situated between 0.7% and 5.0%, depending on its population factor. The population factor ranged between 0% and 4.3% (IPART, 2021, p.1).

In addition to the numerous conceptual and empirical problems with property tax limitations that have been considered in the scholarly literature, several analysts have discovered significant flaws in the new IPART rate peg methodology with its population factor approach. Specifically, while conceding that the introduction of different rate caps for different local authorities represented a substantial improvement in the NSW rate-pegging regime, Drew (2022) identified three main problems with the new IPART rate cap formula.

In the first place, the deployment of population size in the IPART rate cap methodology is problematic for at least three reasons (Drew, 2022). Firstly, given the mix and range of services delivered by NSW local councils, which focus on ‘services to property’ rather than ‘services to people’ (Dollery, Wallis and Allan, 2006), the number of rateable assessments in a given local government area is a much more accurate proxy variable for municipal size than absolute population size (Drew and Dollery, 2014). Secondly, population estimates of intercensal years contain significant errors, ranging from 2.4% in large councils to 15.6% in small local authorities (Drew, 2022). Thirdly, given the potential magnitudes involved, annual population changes can produce substantial changes in rates under the IPART methodology, which can complicate municipal financial planning. Accordingly, if we incorporate a population factor into the rate cap, then it is best to employ a five-year moving average to reduce volatility and partially moderate the large intercensal errors (given that censuses only take place every five years).

Secondly, the LGCI is afflicted by a number of problems that render it unsuitable as a reliable index of municipal costs. Drew (2022) has identified six key problems with the LGCI. Firstly, the LGCI contains too few items and thus cannot accurately represent the typical ‘basket of goods and services’ used by NSW local authorities. Secondly, given the fact that the composition of municipal input consumption varies through time, the weightings embodied in the LGCI should be computed as a three-year moving average instead of a fixed ratio recalculated every four years (IPART, 2021). The current approach of changing the weightings is too infrequent and

thus intensifies volatility. Thirdly, given that the LGCI data used to calculate rate caps in the forthcoming financial year reflects the previous annual price data, it is ‘rearward facing’. This is particularly problematical in a rapidly increasing inflation environment. Fourthly, the LGCI represents a composite of cost indexes drawn from different levels of government - as IPART (2021) itself has acknowledged - rather than a cost index for NSW local government *per se*. Fifthly, the LGCI has no regional weightings for NSW local government despite significant regional cost disparities across NSW. Sixthly, the LGCI ignores the operating environment in which local councils function, even though this represents a major cost factor for local councils. Finally, the IPART methodology for annual rate cap determination places two types of NSW local council at greater financial risk: rural local councils and retirement community councils. For instance, many rural local authorities have had ongoing population decline, together with an ageing population profile. This not only reduces the capacity of people to pay rates, but also generates a higher proportion of pensioner rate rebates, which are not fully funded by NSW government grants (Dollery, Johnson and Byrnes, 2008). Similarly, for local authorities with growing populations substantially composed of retirees, like Port Stephens Council, a high proportion of older residents typically impose considerable additional service demands on local councils. A rate-cap formula that does not accommodate the differential pressures on different types of local council will thus place more local councils at risk.

3. Recommendations for Improving the NSW Rate-capping Regime

In our earlier report, entitled *Rate Capping in New South Wales Local Government: Addressing the Questions Raised in the IPART (2022) Review of the Rate Peg Methodology: Issues Paper and Further Recommendations for Further Improvement* (USU, 2022), we demonstrated that the longstanding rate cap regime in NSW local government had had a damaging impact on municipal performance. This was especially evident in the continuing inadequacy of rate income, related ongoing problems with the financial sustainability of NSW local government and associated insufficient infrastructure maintenance and renewal (Dollery, Johnson and Crase, 2006). In addition, as we have outlined above, the IPART rate cap methodology is seriously deficient and it will further impair the financial sustainability of NSW local government (Drew, 2022).

In our earlier report, we proposed that ‘two alternative generic approaches for improving the NSW local government rating system exist’. We briefly summarise these recommendations below.

Recommendation 1: A ‘First-Best’ Approach to Abolish Rate Pegging

In principle, a ‘first-best’ approach to rate capping would be for the NSW Government to simply eliminate rate pegging and give local authorities the freedom to strike their own rates in light of the preferences of their own communities. As we showed in our earlier report, this approach is in line with both economic theory on optimal municipal property taxation and local democratic accountability, as well as the weight of international and Australian empirical evidence on property tax limitations.

However, in contemporary NSW it would be politically difficult to remove rate capping from NSW local government. In this respect, Drew (2022, p.111) noted that ‘no political party is likely to voluntarily remove existing tax limitation regimes because there is a considerable risk that taxes would be increased soon after, and the party facilitating this would be greeted with the displeasure of voters at the next higher tier election’. Furthermore, ‘because taxation limitations are a politically popular way of responding to cost of living pressures – at no immediate cost to the instigator – their incidence is only likely to increase in future’.

Recommendation 2: A ‘Second-Best’ Approach to Redesigning Rate Pegging

Given these political realities, a pragmatic ‘second-best’ approach would assume that rate capping would remain, regardless of the political composition of the NSW Government. Accordingly, rate reform should instead concentrate on eliminating the worst characteristics of the NSW local government rate-pegging regime. In sum, a ‘second-best’ approach should focus on improving the IPART rate cap methodology.

Drew (2022, pp.111-114; 2022) has offered several proposals for reforming the NSW rate peg methodology, which can be further elaborated. Firstly, different cost indexes should be used for different categories of council: namely, metropolitan, regional, rural and remote local councils. As we have outlined above, the present LGCI employed by IPART is afflicted with numerous problems that render it inappropriate as a foundation for determining cost increases in NSW local government. Given regional discrepancies in municipal costs and municipal resource use across

NSW, especially between metropolitan local councils and their regional, rural and remote counterparts, Drew (2022) holds that different cost indexes should be used for the four chief categories of council (metropolitan, regional, rural and remote local councils). These indexes should employ three-year moving averages of the mix and weighting of the basket of items in the index, a price increase projection for the forthcoming financial year and consideration of the operating environment of the four different types of local council. Using moving averages would reduce volatility and thus partially alleviate the problem whereby some local governments find it difficult to predict future rate caps for budgeting purposes.

The macroeconomic challenges that might face local councils in the next financial year should be considered in the determination of the final rate cap. In sum, the rate cap cannot be simply an empirical exercise; judgements are required on future inflationary pressures and other aligned factors.

Secondly, given differential cost indexes for the different types of council, different rate caps should also be calculated for councils falling into the four main municipal categories in NSW local government (metropolitan, regional, rural and remote councils). This will not only more accurately reflect the different operating environments facing these different types of local authority, but it will also expedite comparisons between local council outcomes in each category. There will thus be greater transparency for local residents and more accountability for local councillors.

Thirdly, we recommended that a rate-cap determination panel, together with the SRV assessment panel, should include at least one scholarly local government expert. Familiarity with property tax limitation theory and sophisticated empirical techniques are vital for the determination of a sound cap. Moreover, scholars enjoy greater independence and can bring fresh insights. Many of the problems associated with recent changes to the rate cap methodology may not have occurred if an informed scholar was on the deliberative panels.

Fourthly, the rate cap should be based on the average rates for each category of property. The extant IPART rate cap methodology computes the annual rate cap for each council based on its total property tax revenue from the previous financial year. If this is modified to a calculation based on typical (mean) rate impost, it will have substantial benefits for local authorities. For example, the construction of new dwellings and businesses in a given local government area will

boost the total tax intake. This will assist local authorities to absorb the costs of growth, including any required local infrastructure investment. It would also render the inaccurate and controversial population growth factor redundant.

To calculate the cap, the average of each category (from the prior time period) should be inflated by the specific cap for the particular type of local council, then multiplied by the number of assessments in the given municipal category as at the most recent record date. Total property tax income would then be equal to the sum of the various category calculations.

A rate peg based on the averages for each municipal category would also stimulate prudent use of minimum rates and base rates. It would thus contribute to greater distributive justice. Furthermore, a method based on averages is more consistent with one central objective of a rate cap; that is, to avoid rate shock for the typical resident. By setting rate pegs on the typical rate imposed on each category of ratepayer, councils are much more likely to avoid rate shock for the typical ratepayer.

Fifthly, in our earlier report, we recommended that the rate cap should operate within a small range rather than be set as a single number. Put differently, a rate cap should not be a single figure for each council, but instead cover a small range of potential rate increases. For example, a rate cap could be '2.4 to 3.0%' rather than simply '2.7%'. This would have several advantages. In the first place, it would reduce much of the 'learned helplessness' and 'blame shifting' inherent in the current NSW rate cap regime. Second, it would enable local councillors to mitigate any error in the calculation or calculation methodology. Third, it would enable local councils to adjust to changes in conditions that occur in the time between promulgation of the rate cap and the start of the new financial year. Fourth, it would permit regulators to include the statistical error term associated with any empirical calculation. Fifth, it would reaffirm democratic accountability and give local councillors greater opportunity to respond to community circumstances and community preferences. A rate cap incorporating a small range would continue to limit the potential for monopolistic excess, but it would respect both the uncertainty inherent in the rate cap calculation as well as local democratic principles.

Our sixth recommendation focused on establishing sensible timelines for SRV nomination dates and applications. In NSW, the current timeline for SRVs could hardly be worse. As Table 1 illustrates, it contributes to a range of avoidable costs. In practice, it often means that local

councils are breaking ‘bad news’ to their local communities immediately prior to Christmas. In the most recent year of delayed elections, the early nomination date meant that many councils delayed their SRV by an additional year. This may well have caused serious financial sustainability problems. Moreover, it increases stress on council staff who often have to give up customary extended periods of leave taken over the festive season. Furthermore, it adds to consultant costs because consulting companies are often obliged to pay premiums to their staff to work during the festive season.

In the Victorian local government system sensible dates apply, as Table 1 shows. Intent to apply is purely optional, as it should be. Furthermore, the applications can be submitted over a long period that allows for much better assessment turnaround times. Furthermore, it is likely that applications are assessed on their own merits rather than sub-consciously compared with other applications.

Table 1: Special Rate Variation Key Dates for NSW and Victoria

Event	NSW Date	Victorian Date	Recommendation
Notification of Intent to apply for a SRV	26 November	31 January*	End of January (optional)
SRV application due date	7 February	1 February until 31 March	Should be submitted any time prior to mid-April
Determinations announced	May 2022	Within two months of receiving the application	Within six weeks of application

* Note this is only an option in Victoria. It is not mandatory to give notice of intent.

Our seventh recommendation is that ‘automatic triggers’ should be employed. A significant problem with a rate peg regime is that it has high political costs. This explains why many local councils are hesitant to indicate intent to apply for an SRV in election years. The problem with delaying SRVs is that a council may fail financially in the interim. Moreover, it may mean that increases need to be higher to compensate for foregone rate revenue for the year(s) deferred.

Political costs might fall by making SRV applications mandatory when certain triggers are met. This would signal to the local community in question that the SRV was required by fiscal prudence rather than by political choice. It would also indicate that the rate cap regime would not add further to the appalling record of local government financial failure in the NSW local government system (Drew *et al.*, 2022).

Financial triggers should contain standard ratios already in use. However, they would require the NSW OLG to employ reasonable benchmarks based on empirical evidence (rather than the current apparently arbitrary numbers). In particular, the following ratios are suggested:

- Operating ratio (over three years)
- Unrestricted Current ratio (with a more suitable benchmark)
- Debt ratio (with a more appropriate benchmark)
- Cash expense ratio (using a more appropriate benchmark)
- Rates outstanding (currently there is no benchmark and a ceiling - rather than a floor - would be best to protect ratepayers).

Note that we have specifically excluded asset maintenance ratios because they are typically too unreliable at present. Moreover, their use may exacerbate the already high levels of distortion to these numbers.

In addition, regulators should consider introducing a trigger whereby a certain turnover in councillors following elections would establish a presumption that a new rating policy is required if it could yield a decrease in total taxation, different categories, changes to minimum and base rates and hence greater distributive justice (Drew, 2022). This would be consistent with greater political accountability with respect to municipal finance.

Furthermore, given the fiscal distress currently experienced by compulsorily amalgamated councils in the disastrous NSW local government *Fit for the Future Program* (Drew, 2022), all compulsorily consolidated councils should submit an SRV application as a matter of urgency.

Finally, our earlier report recommended that the burden of proof should rest with the assessing panel or those who object to the proposed rate cap to offer sound reasons for why it should be

rejected or reduced. Given that SRV applications are publicly available – and should be based on evidence of need according to prescribed criteria - the burden of proof should rest with the SRV assessment panel or those who object to the proposal to provide compelling reasons as to why the SRV should be rejected or reduced. This is particularly the case when local councils have drawn on suitably qualified experts to assist in the preparation of the SRV and where they have provided robust empirical evidence in support of their claims. In sum, reversing the burden of proof along these lines would more appropriately respect the efforts of council staff and the deliberations of politically accountable councillors.

4. Changes to Rate Peg Methodology in IPART (2023) *Final Report*

In its *Review of the Rate Peg Methodology: Final Report*, IPART (2023) made a number of changes to its new rate peg methodology in response to comments on IPART (2022) *Review of the Rate Peg Methodology: Issues Paper*. IPART (2023, p.12) contends that its amended new rate peg methodology ‘will result in rate pegs that more accurately reflect changes in the costs NSW councils incur in providing their current services, and our changes also more accurately consider the diversity of councils across the State’.

In its *Final Report*, IPART (2023) outlines eight revised major dimensions of the new rate peg methodology arising from submissions received on the IPART (2022) *Review of the Rate Peg Methodology: Issues Paper*, as well as further deliberations by IPART. The new approach will determine the rate cap deployed in the 2024-25 financial year. Six noteworthy changes have been made in the *Final Report* (2023):

Firstly, the methodology will calculate three different rate caps for metropolitan, regional and rural groups of councils respectively by computing the costs facing these different categories separately to account for spatially differential cost pressures.

Secondly, the new methodology employs ‘forward-looking indicators’ to measure council cost changes in place of the previous LGCI. The new Base Cost Change (BCC) contains three elements to reflect local council costs: (a) Employee costs (gross wages plus superannuation contributions); (b) asset costs measured by an adjusted Consumer Price Index (CPI) and (c) all other operating costs (administration, insurance and utility costs, but not the Emergency Services Levy (ESL))

Thirdly, incorporate a separate council-specific ESL factor, lagged by a year, to embody the annual change in each council's ESL contribution. This enables local councils to finance their requisite NSW State Emergency Service, NSW Fire and Rescue and NSW Rural Fire Service contributions.

Fourthly, the new methodology will retain the existing approach, but make additional cost adjustments for external factors outside council control, such as climate change imposts and cyber security threats.

Fifthly, it retains the existing population factor in its calculation methodology, but amends its approach where local councils host prison populations by deducting the number of prisoners.

Finally, it maintains the productivity factor in its rate cap methodology and assumes it is zero unless there is evidence to the contrary. Evidence of this kind may require further investigation and consultation on municipal productivity, including other local government reviews involving productivity.

In addition to these changes in the rate peg calculation methodology, in its *Final Report*, IPART (2023) also abandoned its earlier approach of releasing 'an indicative rate peg' in September and a final rate peg in May each year as proposed in the IPART (2022) *Review of the Rate Peg Methodology: Issues Paper, Draft Report*. The earlier draft decision to set ESL factors in May was abandoned due to feedback from stakeholders on its impracticability. Consequently, IPART (2023) has decided to maintain the lag in this measure of ESL contributions. For instance, the ESL factor in the rate peg calculation for the 2024-25 financial year will embody the variation in invoiced ESL contribution totals between the 2022/23 financial year and the 2023/24 financial years.

5. Assessment of the Revised Rate Peg Methodology in IPART (2023) *Final Report*

5.1 Overall Assessment of the IPART (2023) *Final Report*

Overall, the revised methodology for the rate peg is a significant improvement on the former methodology. IPART should be commended for navigating the competing claims of various vested interest groups, made even more difficult because of the clear knowledge gaps demonstrated by many of those making submissions.

We note that IPART was under-resourced to do this work. Moreover, it also operated under significant time constraints. We suggest that the NSW Government ensure that IPART is sufficiently resourced for future reviews it is requested to undertake. Appropriate investment at the beginning of the review process will save potential costs and disruptions in implementation and hence is prudent.

We were concerned at the lack of sophistication of the commercial consultant work employed by IPART. Quite apart from the chequered record of many commercial consultants in public policymaking generally, it is clear that the people engaged for this project lacked the requisite knowledge of economic theory as well as empirical skills required for a sound contribution to the inquiry. We make some more targeted comments on the flawed consultant ‘matters of opinion’ below.

Some of the recommendations in the IPART report clearly represent attempts to satisfy vested interest groups. While we appreciate the political realities of dealing with different stakeholders offering divergent suggestions, we note that the result is often compromise rather than the best possible methodology.

We were particularly concerned about (a) stakeholder bias and (b) misconceptions embodied in stakeholder claims. For example, ratepayer representation appears to have been disproportionately skewed to the older age groups, which is a significant concern given the conceptual and empirical literature on debt bias and intergenerational equity (see, for instance, Buchanan, 1997; Drew, 2022). In addition, it is clear that many ratepayers do not properly understand the economic concept of productive efficiency.

Consistent with our earlier observations in *Rate Capping in New South Wales Local Government: Addressing the Questions Raised in the IPART (2022) Review of the Rate Peg Methodology: Issues Paper and Further Recommendations for Further Improvement* (USU 2022), some aspects of the *Final Report* (IPART, 2023) seem to have gone astray in terms of formal logic. We note with approval that the apparently conflicting ends (in a formal logical sense) were removed from the ‘official’ aims. However, contradictory or confounding goals, such as affordability, simplicity, accuracy and transparency were still imputed into much of the *Final Report* (2023). Merely dropping the conflicting ends from the beginning of the *Final Report* (2023) – but retaining them in its argumentation – does not resolve internal logic flaws.

For instance, in the Final Report (2023, p.9) we are told that the new rate peg methodology allowed ‘councils to vary their income annually to reflect (as far as possible) changes in the costs of providing local government goods and services’ but that it would ‘continue to include a population factor’. According to IPART’s (2023, p. 103) own cited evidence, the second stated ‘objective’ is not consistent with the first. Moreover, for a number of reasons – mostly attributed to the later imputed confounding aims – the *Final Report* (2023) did not specify a methodology that achieved its purported aim in any case.

There were also a number of inconsistencies evident in how principles were applied throughout the *Final Report* (2023). The following examples suffice to demonstrate this observation:

- a. IPART’s (2023) insistence that some data must be ‘forward-looking’, such as CPI data, but its tolerance for other major data inputs that were slightly lagged (like municipal population), or significantly lagged (ESL).
- b. IPART’s (2023) insistence that supplementary increases must be considered because they result in inaccuracy, but its tolerance of inaccuracies arising from supplementary decreases.
- c. IPART’s (2023) contention that population growth requires adjustment because of its purported effects on expenditure, whereas population decline does not require adjustment, despite IPART (2023) evidence suggesting a significant impact on expenditure.
- d. IPART’s (2023) claim that the termination of NSW Government subsidies should be recouped in the rate cap (for ESL), but insufficient NSW Government subsidies should not be recouped in the rate cap (for the Pensioner Discount).
- e. Democratic process is considered a sufficient restraint on rate gouging when it comes to distributive equity for categories of rate payer, but democratic process is not considered a sufficient restraint on rate gouging across all rate categories (when it comes to the rate cap). This inconsistency is particularly problematic because certain categories of ratepayer have less voting power than the ratepayer body as a whole.

Some of these problems were undoubtedly the result of ‘political compromises’ and some the result of constraints outside the control of IPART. However, for decision-making that is both logical and internally consistent, it would be helpful if future IPART inquiries would embody the following principles:

- (i) Employ aims and objectives that are not contradictory.
- (ii) Do not impute contradictory aims after the fact that were not part of the original stated aims.
- (iii) Secure agreement on the desired aims of policy before commencing work.
- (iv) Ensure that the proposed means in fact secure the stated aims.
- (v) Carefully define principles for dealing with conflicts and trade-offs.
- (vi) Consistently employ these principles in deliberations.

Despite the improvements to the rate methodology in the *Final Report (2023)*, further improvements are still necessary. In section 5.2, we advance a number of suggestions to improve the rate peg methodology further.

5.2 Suggestions for Improvements within Constraints of the IPART (2023) *Final Report*

In this report, we offer five major recommendations for improvement and/or clarification of the new rate peg methodology.

1. Use of RBA CPI Forecast

The continued employment of the RBA CPI Forecast in the IPART (2023) *Final Report* methodology is concerning. Indeed, the RBA’s own evidence on the accuracy of its inflation forecasts shows that the use of the RBA CPI prediction data is likely to lead to significant errors. Table 2 uses RBA (2023) data to illustrate the ongoing inaccuracies in the ABS inflation quarterly forecast data from February 2018 to February 2022:

Table 2: RBA Quarterly Inflation Forecast Accuracy from the Forecast Date

	t	t+1	t+2	t+3	t+4	t+5	t+6	t+7	t+8
Feb-18	0.1	0.1	-0.2	-0.3	-0.9	-0.7	-0.7	-0.5	-0.1
May-18	0.0	-0.4	-0.4	-0.8	-0.6	-0.5	-0.5	-0.1	-2.6
Aug-18	-0.1	-0.1	-0.5	-0.3	-0.5	-0.4	-0.1	-2.5	-1.6
Nov-18	-0.2	-0.6	-0.4	-0.7	-0.5	-0.1	-2.6	-1.7	-1.5
Feb-19	0.0	0.2	0.1	0.1	0.1	-2.4	-1.4	-1.2	-1.1
May-19	-0.1	-0.2	-0.1	-0.1	-2.3	-1.3	-1.1	-1.0	1.7
Aug-19	0.0	0.1	0.2	-2.0	-1.1	-1.0	-0.8	1.8	1.0
Nov-19	-0.1	0.0	-2.2	-1.4	-0.9	-0.7	1.9	1.1	1.6
Feb-20	0.2	-1.9	-1.1	-0.7	-0.8	1.9	1.1	1.6	3.2
May-20	0.6	0.4	0.6	1.0	1.1	1.6	2.3	3.8	4.6
Aug-20	-0.2	-0.3	0.1	0.8	1.3	2.5	4.1	5.0	6.1
Nov-20	0.3	0.7	1.5	1.7	2.4	4.0	4.9	6.0	6.4
Feb-21	0.1	0.7	1	1.9	3.8	4.7	5.8	6.3	
May-21	0.4	0.8	1.7	3.7	4.8	5.8	6.2		
Aug-21	0.1	1	2.9	4.5	5.8	6.1			
Nov-21	0.3	2.1	3.4	4.7	5.5				
Feb-22	1.3	2.4	3.5	4.6					

Source: RBA (2023)

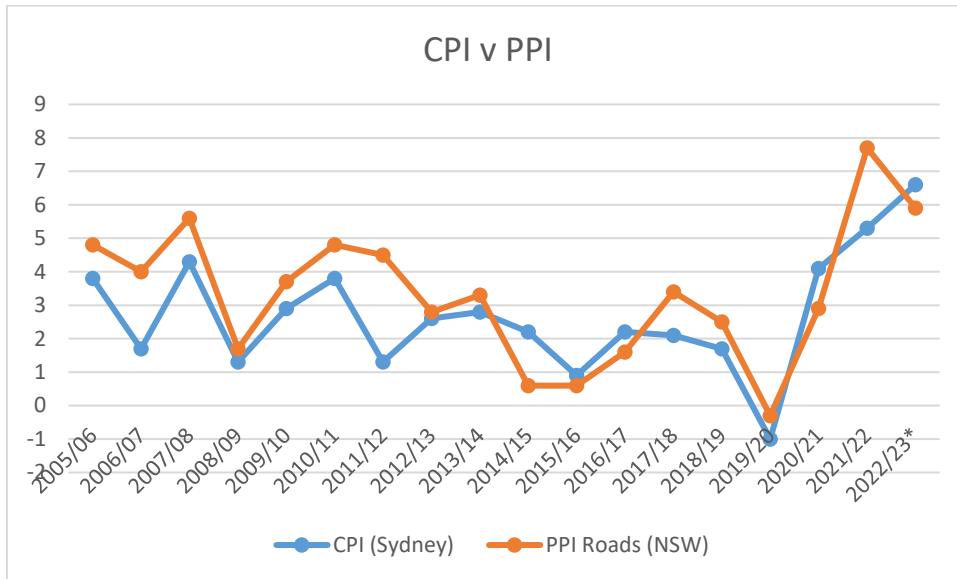
Notably, during periods when central banks are trying to constrain inflationary expectations they will often ‘jawbone’ forecasts (Breton and Wintrobe, 1978): that is, they may deliberately understate inflation projections by a considerable margin to influence market expectations. It is thus reasonable to expect in practice that future forecasts may fall well short of actual inflation.

It is thus concerning that in its *Final Report*, IPART (2023, p. 49) has decided that ‘we would not include a true-up for actual inflation, because doing so would offset the benefits of moving to a forward looking measure’. As can be seen from Table 2, this will result in a very large discrepancy between what local councils are awarded under the rate cap and their subsequent actual increase in costs. Furthermore, an adjustment to inflation data does not entirely negate the benefits of using a forward-looking measure: the responsiveness to future conditions (the asserted reason for using inflation estimates) would still be preserved (since we would simply be retrospectively inserting accuracy into the rate cap).

Refusing to do a ‘true-up’ along these lines is at stark odds with the purported aim of the new rate peg methodology ‘to reflect (as far as possible) changes in the costs of providing local government goods and services due to inflation and other external factors’ (IPART, 2023, p. 9). This will have significant implications for ongoing local government sustainability. Moreover, refusing to undertake a ‘true-up’ for inflation is also at odds with the internal logic of the *Final Report* (2023) since ‘true ups’ are proposed for the other inputs, including population.

We are also concerned with the notion of adjusting the ‘forward-looking’ Consumer Price Inflation (CPI) projections with ‘rearward-looking’ year-on-year differentials in the CPI and Producer Price Index (PPI). Firstly, this approach breeches the internal logic of the *Final Report* (2023): we cannot have a truly prospective measure that includes imputations from ‘rearward-looking’ data. Secondly, it assumes that associations in the past will continue to persist into the future. Induction of this kind is ill advised given that most economists are aware that long-standing relationships between PPI and CPI broke down due to COVID-19, as illustrated in Figure 1.

Figure 1: RBA CPI and PPI Data since 2006



2. Use of Three Categories of Local Council

As we observed earlier in this report, it is important to decompose NSW local councils into categories to reflect more accurately their operating conditions. The use of this approach by IPART (2023) is thus a positive development and much preferred to the previous unreasonable assumption that all NSW local governments face similar cost pressures. Nevertheless, there are potential problems associated with the poorly constructed ABS classification codes, adopted by the NSW Office of Local Government (OLG). In essence, in its *Final Report* IPART (2023) proposes to classify OLG councils 1-7 as ‘metropolitan’, OLG categories 4-5 as ‘regional’ and OLG 8-11 groups as ‘rural’.

This classification system has been known by scholars to be seriously compromised for some time. It employs combinations of arbitrary benchmarks to classify councils. For instance, a local government is considered ‘urban’ if it has a population greater than 20,000, *or* a population density greater than 30 persons per square kilometre, *or* 90% of its population subjectively declared to be ‘urban’. This presents problems because there is nothing special about these particular arbitrary numbers. After all, population and population density fluctuate over time. For instance, Lithgow’s 2022 population estimate was 20,810 and it is declining. In a few years’ time, it could suddenly find itself being classified as ‘rural’ based on population alone. Similarly, Nambucca has only recently achieved the population threshold (i.e. its 2022 population is now

stated as 20,571, but in January 2023 this 2022 population was stated as 20,375). It could thus easily slip back again into the rural category based on its population alone. Furthermore, important factors that have long been demonstrated in the scholarly literature as crucial in local government production functions have been entirely ignored by this classification system. For example, the single largest item of cost for NSW local government – the length of sealed and unsealed roads – are eschewed entirely. This is particularly surprising given that it is reasonable to count the proportion of sealed roads as an important indicator of urbanity.

We argue that IPART should develop a more reliable way of classifying councils, such as a centroid method cluster analysis. In addition, it will be important for IPART to be alert to movements of councils between groups and have a clear policy on how they will respond. It should be stressed that it is unwise to rely on the NSW OLG updating its own classification to accurately reflect changes.

3. Monitoring Award Negotiations with a View to Making Adjustments

We are surprised by the claim attributed to the Centre for International Economics (CIE) (IPART 2023, p.44) that ‘councils would have much less incentive to keep wage increases constrained’ if the Award were used instead of other options. This statement seems to ignore the fact that the main local government bargaining party is indeed Local Government NSW (LGNSW) and not individual NSW local councils. In principle, LGNSW is accountable to all local councillors. However, in practice the LGNSW board is elected on a bundle of issues (and not only Award negotiations). Moreover, the LGNSW award negotiators report back to a non-elected Working Party comprised of Human Resource Officers and one General Manager (GM), further obscuring any link between Award negotiations and NSW local councils. Accordingly, local councils do not have much meaningful control of the wage bargaining process. It follows that changing the employment bargaining incentives is hardly likely to change bargaining outcomes.

We agree with IPART (2023) that the purpose of the rate cap is not to constrain either party in its bargaining but instead to reflect accurately the cost increases experienced by councils. The risks articulated by CIE are thus largely irrelevant to decision-making around the rate cap.

Moreover, we are very concerned about the proposition that ‘if we identify significant divergences between the Award increase and measures of wage increases in the wider economy

we may consider not allowing for full cost-recovery' (IPART, 2023, p.48). This would be at odds with IPART's (2023, p. 9) declaration that the rate cap will 'allow councils to vary their general income annually to reflect (as far as possible) changes in the costs of providing local government goods and services'. Furthermore, the proposed method for monitoring – comparisons to RBA Wage Price Index (WPI) forecasts, minimum wage decisions and other Awards is puzzling. These have little relevance to the wage pressures for local government and thus could only result in erroneous conclusions. Indeed, a lack of relevance and accuracy is why we proposed a change to using the Award in the first place. It thus seems rather odd to use measures acknowledged as inaccurate in the proposed validation process.

4. Population

It is difficult to assess Chapter 6 of the *Final Report* (IPART 2023) owing to its confused presentation, which considers population in no logical order, ranging from prison populations to supplementary valuations and then back to direct population concerns.

In essence, population is fundamentally the wrong unit to impute into the rate cap for several reasons. Firstly, municipal rates are levied on properties (or specifically unimproved land value that has no meaningful association with population) and not on people *per se*. Secondly, on IPART's (2023, p. 103) own cited evidence, population is not the best reflection of costs. For example, we are told that a 1% increase in properties results in a 1.02% increase in expenditure, but that a 1% increase in population has a much weaker response of just 0.85%. This means that the population factor over-compensates some councils. It also explains the *prima facie* perplexing results of IPART's efforts on measuring expenditure elicited from population decline.

Moreover, the regression work that IPART has solicited from the CIE consulting company is of extremely poor quality and it further underlines the dangers of placing reliance on empirical evidence derived from a commercial consultant (Dollery, 2018). Indeed, in the CIE calculations there appears to have been (a) no controls for population density (despite the overwhelming importance of economies of density to local government); (b) no controls for length of disaggregated roads (heedless of the fact that roads are the single largest cost element in NSW local government) as state above; and (c) no socio-economic variables (even though we know that demographics drive costs, as in childcare or home care).

Furthermore, the CIE employs fallacious reasoning. For instance, we are told that population is preferred because it is ‘independent’ of councils. However, with respect to the number of properties, councils are unlikely to try to game the rate cap by changing their approval practices. After all, (a) most approval processes are codified and rules-based and (b) Greater Sydney local councils have limited control over development applications anyhow. Moreover, council data on property approvals is rigorous since local councils know how many rate notices they issue and this data could easily be audited if real concerns emerged. By contrast, we know that the ABS population data *is* prone to significant error.

We are also told that population might be useful because it is used by the Local Government Grants Commission (LGGC). However, it has been demonstrated that the LGGC has not effectively managed the intent of their enabling legislation, which is ‘horizontal fiscal equalisation’. Following LGGC practice is thus unwise (see, for example, Drew and Dollery, 2014; Drew, 2022). In addition, the CIE consultants fret that occupancy rates could change, but this would only be materially important if population exerted a decisive effect on costs, which IPART’s (2023) own evidence suggests is not the case¹. Furthermore, the CIE contends that the number of rateable properties could change prior to occupancy, but the same argument applies *ipso facto* to population data, which can also change before it is officially recorded. For instance, people give birth and die on days other than the census day.

The CIE consultants are correct that population data is better correlated to health, education and community services. However, in Australian fiscal federalism education and health are federal and state-funded functions and form only a relatively small part of most council budgets (which explains the overall response rates calculated by the CIE for expenditure as a whole).

Using population data to represent the change in costs experienced by councils results in the sort of problems cited by IPART from various submissions. A population figure will disproportionately disadvantage councils with large business sectors (including tourist

¹ In this regard a simple thought experiment is illuminating. Imagine a household where a new baby is born. How does this new person affect the single largest item of council expenditure (roads)? Will the roads suddenly need more maintenance because the car has a baby capsule strapped into the back? Will we suddenly need more footpaths, or street lighting, a bigger HR department, or an additional person in the council finance team? How will the new birth affect around a third of local government expenditure (depreciation)? Will council trucks and computer equipment have their useful lives shortened? Would this effect double if the family gave birth to twins instead?

businesses). For instance, it is common in Australian metropolitan regions, where most people travel to a different local government area for work or recreation, but pay their council rates to the council area in which they reside (Dollery, Crase and Johnson, 2006). The use of population will also disadvantage areas with large rural farmlands. In these local government areas the population per household is typically lower in aggregate, yet the length of roads required to service them is much higher.

In addition, the oft-cited goal of maintaining per capita income in local government areas (to justify the use of a population factor) is illusory. After all, in the *IPART Final Report (2023, p.9)* this is not an objective of rate capping in any case. The rate cap is meant to reflect the change in the costs of providing municipal services, not maintain a given level of revenue per person. Inclusion of the population factor is simply not consistent with the purported aim of the NSW rate cap.

As we have already noted, and which IPART (2023) has conceded, population data contains substantial errors that become apparent every census. A 2016 study by the ABS (2023), demonstrated how large these errors are and furthermore which councils are most at risk from this methodological flaw. This is shown in Table 3 below:

Table 3: ABS (2023) Study of Population Estimate Errors.

Size of Statistical Area 2 (SA2) (Population Range)	Number of SA2s (by Population)	Average Absolute Intercensal Difference (Percentage)
1,000 to 2,999	92	7.6
3,000 to 4,999	336	5.4
5,000 to 6,999	312	3.7
7,000 to 9,999	367	3.1
10,000 to 14,999	469	2.5
15,000 to 19,999	311	2.1
20,000 and over	269	2.4

We note that IPART (2023, pp. 103-104) proposes to ‘true-up’ the population data to redress the known substantial errors after each census employing the following constraints:

1. ‘This true-up would be for all councils, but not adjust the population factor below zero’.
2. ‘The recommendations of the report were to include a true-up where councils had a difference in estimated residential population and actual census data greater than 5%’.

These proposed procedures are problematic. Firstly, constraint 1 above seems to suggest that councils with population ‘over-estimations’ will have been allowed to pass on rate increases greater than warranted according to actual population change. Secondly, constraint 2 means that only the worst of the inaccuracies are redressed. Furthermore, in the IPART *Final Report* it is

uncertain whether this true-up methodology incorporates some sort of indexing to reflect accurately the true value of revenue previously foregone.

The true-up decision is inconsistent with the purported purpose of the rate cap methodology; i.e. to reflect the actual increase in costs experienced by councils. Moreover, it stands in contrast to other parts of the *Final Report (2023)*, where ‘true ups’ on important data inputs are not undertaken (such as the CPI). In addition, the procedure for only partially correcting known errors (even when material) seems odd when set against the complexity and effort involved to correct for prison populations, which in some cases might be expected to be much less material.

Indeed, we are concerned that the removal of prison populations will mean that the rate cap will undercompensate councils (especially small councils). The notion that prison populations do not impose costs on councils seems to suggest prisons do not increase the flow of traffic for visitors, prison guards, supply trucks and the like. Moreover, in NSW prisons are not ordinarily subject to municipal rates and hence may not provide income to councils to meet the indirect burdens that they impose. In its *Final Report*, IPART (2023) concedes that further research is required on this question. We suggest that the requisite empirical research should have been completed prior to making an adjustment that could significantly disadvantage small councils. Moreover, the requisite analysis should now be prioritised.

Indeed, the councils most at risk from the population factor decisions tend to be rural local governments with small populations. First, they are the most likely to have large errors imputed into intercensal population estimates (according to the aforementioned ABS, 2023). Secondly, they are the most likely *not* to have an appropriate adjustment made when the correct figures finally come to light.

In addition, small rural councils also tend to be the most likely to suffer from population decline. In its *Final Report*, IPART (2023, p.97) provides some data that seems to suggest that ‘population decline does appear to put a small upward pressure on operating costs per capita’. However, they demure from including these additional costs in the population factor. This is problematical because IPART is implicitly arguing that while population growth must be compensated for, population decline (which the IPART tells us might have a bigger impact on expenditure) does not require compensation! Moreover, it is interesting to think that both population growth and population decline could both have expenditure implications. We note

that IPART (2023, p. 97) states that ‘further investigation would be required to be definitive about [the] relationship’. In view of the importance of this issue to the small rural councils, which already tend to be the least sustainable, it would seem prudent to prioritise this research as soon as possible. However, we do caution that this empirical research should be undertaken by a party that demonstrates considerably more competence than some of IPART’s previous commercial consultants.

The final substantive matter on the population factor relates to supplementary valuations. Increases to supplementary valuations are adjudged deserving of adjustments by IPART, but not supplementary valuation decreases. IPART (2023, p. 92) informs us that in 2020/21 fifteen councils suffered supplementary revaluation declines affecting income to the tune of 0.20%. This is a material disadvantage readily amenable to quantification. It thus puzzles us why this is not done in the rate cap methodology.

IPART’s (2023, p. 93) rationale seems to be that ‘it is unclear that negative supplementary valuations are caused by population change’. However, many positive supplementary valuations are also not caused by population change. For instance, they occur when farmland is rezoned to allow for the construction of a truck stop or the like. This represents a further example of inconsistent logic in action in the *Final Report*. Moreover, it is made worse by the insistence on sticking with an objective of maintaining revenue per capita despite its extraneous relationship with the aim of the rate cap methodology (to reflect price changes).

5. Rounding

The *Final Report* (2023) does not seem to specify how the inputs to the rate cap, as well as the rate cap itself, are rounded. While there is a footnote suggesting that rounding of the final figure might be to one decimal place, no firm decision is evident.

Obviously rounding is important when some factors are applied to millions of dollars. Moreover, the various rounding decisions for inputs will interact with respect to the final rate cap. Within the constraints of significant figures, rounding should be undertaken and the full methodology outlined so that it can be well understood. How and when rounding should be performed is thus important. IPART must thus outline in detail how rounding applies to its amended rate peg methodology in its *Final Report*.

References

- Breton, A. and Wintrobe, R. (1978), 'A theory of 'moral' suasion', *Canadian Journal of Economics*, 41, 210–219.
- Buchanan, J. (1997), 'The Balanced Budget Amendment: Clarifying the Arguments', *Public Choice*, 90: 117-138.
- Dollery, B. E. (2018), 'Policy-Based Evidence Making in Local Government: The New South Wales' Municipal Merger Program, 2011 to 2017', *Economic Papers*, 37(4), 363-373.
- Dollery, B. E., Crase, L. and Johnson, A. (2006), *Australian Local Government Economics*, Sydney, University of New South Wales Press.
- Dollery, B. E. Johnson, A. and Byrnes, J. (2008), 'Cost Shifting in Australian Local Government: An Analysis of the Spatial Impact of Pensioner Rate Concession Rebates in New South Wales', *Australian Geographer*, 39(4), 467-478.
- Dollery, B. E., Wallis, J. L. and Allan, P. (2006), 'The Debate That Had to Happen But Never Did: The Changing Role of Australian Local Government', *Australian Journal of Political Science*, 41(4), 553-567.
- Drew, J. (2022), *Saving Local Government*. Singapore: Springer.
- Drew, J and Dollery, B. E. (2014), 'Keeping It In-House: Households versus Population as Alternative Proxies for Local Government Output', *Australian Journal of Public Administration*, 73(2), 235-246.
- IPART (2021), *Review of the Rate Peg to include Population Growth: Final Report*, IPART, Sydney NSW.
- IPART (2022), *Review of the Rate Peg Methodology: Issues Paper*, IPART, Sydney NSW.
- IPART (2023), *Review of the rate peg methodology: Final Report*, IPART, Sydney NSW.
- USU (2022), *Rate Capping in New South Wales Local Government: Addressing the Questions Raised in the IPART (2022) Review of the Rate Peg Methodology: Issues Paper and Further*

Recommendations for Further Improvement, New England Education and Research Proprietary Limited, Armidale NSW.

**RATE CAPPING IN NEW SOUTH
WALES LOCAL GOVERNMENT:
ADDRESSING THE QUESTIONS
RAISED IN THE IPART (2022)
*REVIEW OF RATE PEG
METHODOLOGY: ISSUES PAPER
AND FURTHER
RECOMMENDATIONS FOR
IMPROVEMENT***

Contacts

Disclaimer

This Report was prepared by Brian Dollery on behalf of New England Education and Research Proprietary Limited for the United Services Union (USU). The author is grateful for the assistance of Professor Joseph Drew. This Report was produced for the USU as a strictly independent Report. The opinions expressed in the Report are thus exclusively the views of its author and do not necessarily coincide with the views of the USU or any other body. The information provided in this Report may be reproduced in whole or in part for media review, quotation in literature, or non-commercial purposes, subject to the inclusion of acknowledgement of the source and provided no commercial use or sale of the material occurs.

Table of Contents

1. Introduction
2. Genesis and Evolution of Rate Capping in NSW
3. Conceptual Foundations of Rate Capping
4. International Empirical Evidence on Property Tax Limitations
5. Australian Empirical Evidence on Rate Capping
6. Official Findings on Rate Capping
7. IPART Rate Peg Methodology
8. Problems with the IPART Rate Peg Methodology
9. Twenty Questions in the IPART *Review of Rate Peg Methodology: Issues Paper*
10. Recommendations

1. Introduction

Under section 9 of the *Independent Pricing and Regulatory Tribunal Act 1992*, the NSW Minister for Local Government Wendy Tuckerman asked the Independent Pricing and Regulatory Tribunal (IPART) to investigate and report on the current NSW rate peg methodology. In particular, the Minister for Local Government sought IPART to investigate and make recommendations on the following six matters:

1. 'Possible approaches to set the rate peg methodology to ensure it is reflective of inflation and costs of providing local government goods and services';
2. 'Possible approaches to stabilizing volatility in the rate peg, and options for better capturing more timely changes in both councils' costs and inflation movements';
3. 'Alternate data sources to measure changes in councils' costs';
4. 'Options for capturing external changes, outside of councils' control, which are reflected in councils' costs';
5. 'The effectiveness of the current LGCI approach'; and
6. 'Whether the population growth factor is achieving its intended purpose'.

In reviewing these matters, the Minister for Local Government required IPART to have regard for the following factors:

- (a) 'The Government's commitment to protect ratepayers from excessive rate increases and to independently set a rate peg that is reflective of inflation and cost and enabling financial sustainability for councils.
- (b) The differing needs and circumstances of councils and communities in metropolitan, regional and rural areas of the State.
- (c) Ensuring the rate peg is simple to understand and administer'.

Following this request, IPART (2022) published its *Review of Rate Peg Methodology: Issues Paper* on 29 September 2022. In the *Issues Paper*, IPART (2022) identified twenty matters on which it sought input from both the NSW local government sector and the broader general public by 4 November 2022:

1. To what extent does the Local Government Cost Index reflect changes in councils' costs and inflation? Is there a better approach?
2. What is the best way to measure changes in councils' costs and inflation, and how can this be done in a timely way?
3. What alternate data sources could be used to measure the changes in council costs?
4. Last year we included a population factor in our rate peg methodology. Do you have any feedback on how it is operating? What improvements could be made?
5. How can the rate peg methodology best reflect improvements in productivity and the efficient delivery of services by councils?
6. What other external factors should the rate peg methodology make adjustments for? How should this be done?
7. Has the rate peg protected ratepayers from unnecessary rate increases?
8. Has the rate peg provided councils with sufficient income to deliver services to their communities?
9. How has the rate peg impacted the financial performance and sustainability of councils?
10. In what ways could the rate peg methodology better reflect how councils differ from each other?
11. What are the benefits of introducing different cost indexes for different council types?
12. Is volatility in the rate peg a problem? How could it be stabilised?
13. Would councils prefer more certainty about the future rate peg, or better alignment with changes in costs?
14. Are there benefits in setting a longer term rate peg, say over multiple years?
15. Should the rate peg be released later in the year if this reduced the lag?
16. How should we account for the change in efficient labour costs?
17. Should external costs be reflected in the rate peg methodology and if so, how?
18. Are council-specific adjustments for external costs needed, and if so, how could this be achieved?
19. What types of costs which are outside councils' control should be included in the rate peg methodology?
20. How can we simplify the rate peg calculation and ensure it reflects, as far as possible, inflation and changes in costs of providing services?

The present Report was prepared in response to the IPART request for comment on its *Review of Rate Peg Methodology: Issues Paper*. By way of background, the Report presents existing international and Australian conceptual and empirical work on municipal property tax limitations, as well as the findings of a number of recent official inquiries and reports into rate-capping in NSW. Drawing on this material, the Report then addresses the twenty questions posed by IPART (2022) in its *Review of Rate Peg Methodology: Issues Paper*.

The Report consists of ten main parts:

- Section 2 briefly summarises the main arguments that have been employed in the debate over rate-pegging in NSW local government by way of institutional background.
- Section 3 provides a synoptic outline of the theoretical literature on property tax limitations, including rate-pegging.
- Section 4 offers a succinct account of the international empirical literature on property tax limitations.
- Section 5 summarizes the extant Australian empirical literature on rate-capping.
- Section 6 considers the findings of a number of recent official reports on the operation of rate-pegging on NSW local government.
- Section 7 briefly outlines the new IPART rate-pegging methodology.
- Section 8 describes the numerous problems with the IPART methodology.
- Section 9 addresses the twenty questions raised by IPART in its *Review of Rate Peg Methodology: Issues Paper*.
- Section 10 concludes the Report by offering two alternative generic recommendations for dealing with the manifold problems besetting the current NSW rate-pegging regime.

2. Genesis and Evolution of Rate Capping in NSW

Legally enforced constraints on increases in property taxes – colloquially known as ‘rate capping’ or ‘rate pegging’ in Australia – form part of a broader category of state government imposed limitations on the expenditure and taxation by local government, including property taxation (Dollery and Wijeweera, 2010). Under its longstanding rate capping regime, the NSW Government determines the maximum annual percentage amount by which a local council can increase its rates income for a given financial year. The rate peg does not apply to stormwater, waste collection, water and sewerage charges. Moreover, local authorities enjoy

discretion to determine how to allocate the stipulated rate peg rise between different categories of ratepayer in their respective local government areas.

A rate cap was first introduced in NSW local government in 1901 and it lasted until 1952 (Dollery, Crase and Johnson, 2006), when it was discontinued due to its 'impracticality' (NSW Local Government and Shires Association, 2008, p.16). The modern NSW rate-pegging regime began with the adoption of the 1977 *Local Government (Rating) Further Amendment Bill*, which was subsequently amended to its contemporary form in 1978. The initial motivation for the imposition of the rate peg legislation derived from the period of high inflation in the 1970s. For example, over the period 1973 to 1976, property taxes rose by an average of 188 per cent, while average weekly earnings over the same period increased by only 75 per cent, with the inflation rate at 56 per cent (Johnson, 2001, p.5).

Rate pegging has been controversial in NSW since its inception and it has generated considerable debate (Johnson, 2001). IPART (2008, p.55) has summarised four major arguments that have been proposed in support of the NSW rate-capping regime. Firstly, it has been claimed that municipal revenue regulation through rate pegging prevents the exploitation of monopoly power by local authorities in the provision of local services. Secondly, advocates of rate pegging have argued that it assists in preventing 'cross-subsidisation' and imposes restrictions on the 'provision of non-core services and infrastructure that might prove unsustainable to ratepayers'. Thirdly, proponents contend that rate capping manages governance risk in the local government sector by constraining council income and thereby limiting council expenditure. Finally, it has been argued that rate pegging reduces the ability of local councils to divert funds from essential infrastructure to other projects as well as expenditure on 'marginal services' that are better provided by the private sector or the voluntary sector.

Opponents of rate pegging have contested all of these arguments (Dollery and Wijeweera, 2010). For instance, the claim that rate capping restrains monopoly power and thus increases the supply of municipal services is problematic since rate pegging curtails municipal output by restricting funding. Moreover, the rate peg does not apply to several sources of municipal income, such as water and sewage charges, where monopoly power could also be exploited. Along analogous lines, it is difficult to see how rate capping will dampen cross-subsidisation, given that municipal fees and charges are likely to rise to counteract the negative impact of

rate pegging on municipal revenue. Furthermore, rate pegging has not constrained the provision of ‘non-core’ local services.

In this regard, Dollery, Wallis and Allan (2006) have demonstrated that an ongoing shift in all Australian state and territory local government systems away from a traditional emphasis on ‘services to property’ towards ‘services to people’ has occurred, including in NSW local government. This finding also undermines the claim that rate pegging limits the ability of councils to divert funds from essential infrastructure to other projects as well as the argument that expenditure on local services is better delivered by the private sector and the voluntary sector.

IPART (2008, p.55) has also identified four main arguments against rate capping in the NSW debate. Firstly, it has been claimed that rate pegging constrains the ability of local authorities to provide local services by limiting their financial capacity. Secondly, opponents of rate capping have argued that it has generated a sizeable infrastructure backlog in NSW local government. Thirdly, it is claimed that rate pegging has obliged local councils to impose higher user pays charges to compensate for their loss of revenue from limitations on rate increases. Finally, foes of rate capping have claimed more broadly that the imposition of rate pegging is an attack on local autonomy and the accountability of local government.

Some of these arguments are convincing (Dollery and Wijeweera, 2010). For example, rate pegging clearly constrains the capacity of local councils to provide local services. If the net effect of rate pegging has been to constrain aggregate municipal income, then it must have limited local service provision to some degree. Similarly, the argument that rate capping has stimulated an increase in fees and charges is especially convincing. Indeed, the NSW Treasury (2008, p.14) has itself noted that ‘constraints on general revenue distort revenue raising sources and result in higher user charges’.

However, the claim that rate pegging has spawned a local infrastructure backlog is less convincing because it seems that the problem is endemic to the entire country. In its National Financial Sustainability Study of Local Government, PriceWaterhouseCoopers (2006) established that not only was a large number of local councils in all Australian local government jurisdictions financially unsustainable in the long run, but that most local authorities faced a massive local infrastructure backlog, regardless of the rate setting regime in their state. Since this problem is endemic to all Australian jurisdictions and it does not

seem to be more acute in NSW, the NSW local infrastructure backlog cannot thus be solely ascribed to rate pegging.

In addition to these arguments against rate capping in NSW local government, the Local Government and Shires Associations of NSW (2008) proposed a more general argument against rate capping embedded in broader political terms. It claimed that rate pegging has a wider unintended ‘dampening’ effect on rates than simply the pegged limit. Along these lines, the Association (2008, p.14) contended that ‘one likely explanation for the dampening effect is that rate pegging provides a public framework and creates public expectations about maximum rate increases, placing political pressure on councils to stay within the limit and not seek special variations’.

A second element of this argument is that rate capping provides an avenue for local councils to engage in politically expedient ‘blame shifting’ onto the NSW state government. This phenomenon has also been described as ‘learned helplessness’ by Drew (2021). The Association (2008, p.15) argued that rate capping ‘provides an easy default option from both a political and managerial perspective’ since (a) all rate increases can be attributed to the state government; (b) the need for community consultation to justify rate increases is weakened; (c) adhering to the rate peg limit avoids the problems contingent on Special Rate Variation applications; (d) ‘councils can blame the state government for their financial deficiencies’; and (e) the existence of rate capping enables councils to avoid long-term planning. The net result of these factors has been the ‘under-provision of community infrastructure and services’, the emergence of a local infrastructure backlog and an ‘undermining’ of both the financial sustainability of councils and democratic accountability at the local level.

3. Conceptual Foundations of Rate Capping

A voluminous theoretical and empirical literature has examined central and state government limitations imposed on municipal expenditure and revenue-raising activities, including property taxation or rating (see, for instance, Florestano, 1981; Temple, 1996; Mullins and Wallin, 2004; Anderson, 2006; McCubbins and Moule, 2010). Although the majority of this scholarly effort has focused on American local government, where state-imposed constraints on local fees, charges and taxes are common (Figlio and O’Sullivan, 2001), researchers have also studied other local government systems, including European local government systems (Boadway and Shah, 2009; Blom-Hansen *et al.*, 2014) and Australian state and territory local

government systems (Dollery and Wijeweera, 2010; Drew and Dollery, 2015; Dollery and McQuestin, 2017; Yarram, Tran and Dollery, 2021).

The economic foundations for rate pegging derive from the normative prescriptions of standard neoclassical economic theory: local government enjoys a monopoly in essential local service provision. Consequently, in line with other monopoly suppliers, local government will offer these local services at excessive prices and/or in an inefficient manner. This provides the justification for regulation by higher tiers of government to ensure efficient and equitable outcomes (Bailey, 1999). However, in accordance with economic theory, regulation must be judiciously employed since badly designed and implemented regulation can generate worse outcomes than an absence of any regulation (Hillman, 2005).

To maximise economic efficiency, optimal regulation should seek to achieve (a) allocative efficiency, whereby the composition of local services delivered must correspond with local community preferences, and (b) productive efficiency, where local services must be produced at the lowest possible cost. In addition, optimal regulation should attempt to ensure that equity objectives are achieved. For example, essential local services should be delivered to low income households by local authorities at reasonable prices.

It should be stressed that the effective application of regulation is notoriously difficult in all spheres of economic activity, including in local government systems (Bos, 1994). Moreover, regulation is further complicated in local government since local councils enjoy the legal authority to tax, which is a monopoly power lacking in both the private sector and in most public utilities. In addition, in local municipal revenue regulation through rate pegging, regulatory agencies face additional problems since they cannot regulate the specific prices of particular local services but rather must regulate the ‘tax-price’ of a whole genre of municipal goods and services that are mostly unpriced.

In the theoretical literature, two conceptual models have attempted to explain property tax limitations, such as rate capping (Drew and Dollery, 2015). In the first place, agency theory (Jensen and Meckling, 1976) holds that local citizens (as principals) fear that ‘agency failure’ by local councils (as agents) can induce excessive local government outlays. Accordingly, local residents thus seek state government intervention through rate pegging to limit excessive expenditure by local authorities.

Municipal councillors are typically elected every four years in NSW local government and local residents can remove elected representatives who do not embody their best interests.

However, the effectiveness of local elections for minimising ‘agency failure’ is limited in at least three ways: (a) high information costs mean that local citizens are often ignorant of excessive and/or unwarranted municipal expenditure (hence the suggestion by Drew (2021) for compulsory short financial sustainability statements to be posted to voters prior to elections); (b) the long period between elections allows extensive ‘agency failure’ to develop; and (c) Cutler *et al.* (1999, p. 320) have argued that ‘candidates come as bundles, so that incumbents might be able to spend more and maintain their position if they satisfy people’s views along other dimensions’. Dollery *et al.* (2006) have gathered these arguments to develop a public choice approach to rate pegging based on voter scepticism over their ability to exercise control of municipal outlays, which gives rise to a desire for state government intervention.

Secondly, personal finance theory (Cutler *et al.*, 1999) holds that local citizens evaluate the value of the local services they receive from their local authorities relative to their municipal tax burden. Thus, the higher the perceived rate of property tax, the more likely it is that a local resident will support rate pegging. Furthermore, significant rises in property taxes predispose local citizens to support property tax limitations. This argument is especially relevant in NSW local government since municipal rates are highly visible as a result of regular rate bills being sent on a quarterly basis to local residents by local councils (Drew and Dollery, 2015).

4. International Empirical Evidence on Property Tax Limitations

Notwithstanding the substantial empirical literature on the impact of revenue and expenditure limitations on local government, a degree of uncertainty exists over their likely consequences (Dollery and McQuestin, 2017). However, extant empirical evidence has shown that important unanticipated and unintended effects frequently occur (Skidmore, 1999; Mullins and Wallin, 2004). For instance, Temple (1996) demonstrated that rate pegging reduced outlays on local services more than on local administration.

From an Australian local government perspective, the international empirical literature has illuminated two relevant aspects of rate pegging (Dollery and McQuestin, 2010; Yarram, Tran and Dollery, 2021). Firstly, limitations on property tax increases can encourage local authorities to raise income from revenue sources other than property taxes. For instance, in his study of 29 American states, Shadbegian (1999) demonstrated that many local governments substituted foregone property tax income with monies raised under

‘miscellaneous revenue’. Along analogous lines, Skidmore (1999) found similar outcomes for 49 American states. In a more recent study, Kousser *et al.* (2008) demonstrated that most US state local government systems increased fees and charges following the application of property tax limitations. Moreover, Mullins and Joyce (1996) examined 48 American states over the period 1970 to 1990 and established that while property tax limitations constrained local taxes, this foregone revenue was replaced by increases in fees and charges. In their study of 1,400 American local governments, Preston and Ichniowski (1991) showed that property tax limitations decreased tax revenue but boosted ‘other revenue’.

Secondly, international empirical evidence has demonstrated that property tax limitations do not have a uniform impact across all local councils in a given local government system. By contrast, the impact of rate pegging hinges largely on the characteristics of local authorities. For instance, Brown (2000) showed that in the Colorado local government system the effects of property tax limitations depended on council size by population, with their impact more pronounced in small local authorities. In an analogous study, Mullins (2004) demonstrated that property tax limitations were more potent in poor local authorities.

5. Australian Empirical Evidence on Rate Capping

To date, five scholarly studies have examined the impact of rate pegging in Australian local government. Firstly, Dollery and Wijeweera (2010) investigated rate capping in NSW local government, the conceptual basis for rate capping and the controversy over its desirability, as well as its economic impact on NSW local government financial sustainability compared to other Australian local government systems. Dollery and Wijeweera (2010, p.74) drew two major conclusions from their empirical analysis. Firstly, ‘rate-pegging has achieved its basic objective of slowing increases in NSW council rates over time relative to other Australian jurisdictions’. Secondly, ‘rate-pegging has enjoyed ongoing and strong public support’ that suggests ‘the operation of an efficient “political market” in NSW’ (Dollery, Crase and Byrnes 2006, p. 397).

Secondly, Drew and Dollery (2015) examined NSW local government with its rate peg compared with (then) uncapped Victorian local government to determine the probable impact of rate capping on Victorian local government. Three dimensions of municipal performance were considered. First, Drew and Dollery (2015) evaluated inter-municipal revenue effort equity by assessing residential tax effort. Residential tax effort measures the proportion of residential rates paid with respect to the total annual incomes accruing to local residents in a

given local government area. Drew and Dollery (2015) found that rate pegging in NSW had significantly *decreased* inter-municipal equity, possibly due to the compounding impact of a rate-cap where initial residential tax effort differed between local councils.

Second, Drew and Dollery (2015) considered the effects of rate capping on financial sustainability by considering local government liabilities per household for NSW and Victorian councils over the period 2009 to 2013. They found that NSW had much greater levels of council debt per household. They also considered the average infrastructure renewal ratio in NSW and Victoria as a measure of the infrastructure backlog and found that NSW had a much larger local infrastructure backlog.

Finally, Drew and Dollery (2015) investigated the claim that rate pegging forced local councils to become more efficient. Using data envelopment analysis (DEA) to study the relationship between inputs and outputs, Drew and Dollery (2015, p. 145) found empirical evidence indicating a 'slightly higher average municipal efficiency for Victorian councils' – a finding starkly at odds with the claims of rate cap proponents.

In a third study, following the approach used by Drew and Dollery (2015), Dollery and McQuestin (2017) empirically investigated the likely impact of the imposition of a rate cap in South Australian (SA) local government by comparing the performance of SA local government with its NSW counterpart using three separate performance indicators (revenue effort, financial sustainability and operational efficiency) for the period 2013 to 2016. Dollery and McQuestin (2017, p.84) found that for revenue effort 'the results from our stratified sample show that rate-capping in NSW has not served to reduce inter-municipal revenue effort inequities'. Furthermore, rate capping is thus 'most unlikely to minimise these inequities in SA local government'. Secondly, they established that the 'claims made by advocates of rate-pegging that it improves financial sustainability are rebutted by our findings'. Employing council debt per capita as a proxy for financial sustainability, Dollery and McQuestin (2017) showed that 'NSW local authorities have much higher debt than their SA counterparts despite the four decade long rate-pegging regime in NSW'. Dollery and McQuestin (2017, p.84) found that the operational efficiency of local councils did not increase under rate capping. Using council expenditure per capita as a measure of the operational efficiency of local authorities, Dollery and McQuestin (2017, p.84) showed that 'rate-pegging does not increase the efficiency of local councils: for each year in our sample, the efficiency of NSW councils falls well below SA councils'.

Dollery and McQuestin (2017, p.84) determined that ‘on all three dimensions of local government examined in our empirical analysis, we find SA councils performance better than NSW local government notwithstanding the latter’s longstanding rate-pegging policy’. Moreover, relative to NSW, ‘SA municipalities exhibit superior performance’. Given these findings, Dollery and McQuestin (2017, p.84) argued that ‘the empirical evidence presented in the paper demonstrates that rate-pegging should not be imposed on SA local government and instead other more promising policies [should be] considered’.

In the fourth study, Yarram, Tran and Dollery (2021) employed expenditure data covering the period 2014/15 to 2017/18 to empirically investigate the short-term effects of rate capping on municipal expenditure in the Victorian local government system to determine whether it had differential effects on expenditure by different categories of local council. Yarram, Tran and Dollery (2021, p.11) determined that ‘it is clear that the impact of rate capping varies between urban and rural councils’. Moreover, ‘rural councils that generally rely more on assessment rates are unsurprisingly unable to incur higher expenditure following a rate-capping’. This contrasts sharply with urban councils ‘that are able to increase total expenditure, perhaps through other sources of funding’. Moreover, with respect to the impact of rate capping on different kinds of municipal expenditure, Yarram, Tran and Dollery (2021, p.11) found that ‘rate-capping reduces outlays, especially on aged and disabled services, in both rural and urban councils’. Furthermore, they found that ‘there is a reduction in expenditure on family and community services in urban councils’.

Yarram, Tran and Dollery (2021, p.17) concluded their study by considering it in the context of the earlier empirical studies on the impact of rate capping on Australian local government. They noted that ‘the findings of this study are broadly consistent with previous results of Drew and Dollery (2015) who found that rate-capping in NSW made its local councils more constrained compared to councils in Victoria before the rate-capping’. They noted further that ‘our findings are also consistent with Dollery and McQuestin (2017) who established that NSW councils under a rate-capping regime suffered in terms of unsustainable financing and lower operational efficiency compared to councils in SA, which did not have any rate limitations’.

In terms of the international empirical literature on the impact of property tax limitations, Yarram, Tran and Dollery (2021, p.17) noted that ‘the findings of this study are also consistent with the findings of Skidmore (1999) and Kousser *et al.* (2008), who established

that limitations on tax and expenditure at the state level are often frustrated by increased user charges’.

Finally, Nahum (2021) considered the impact of the imposition of a rate cap on Victorian local government. Nahum (2021, p.5) argued that ‘far from “protecting” ratepayers (that is, residents), rate caps hurt them, in several different ways’, including ‘compromised service delivery’, lower employment levels and/or lower employee wages amongst those local residents employed in local government, higher fees and charges by local councils and ‘lower expenditures flowing back into the private sector’.

Nahum (2021) examined the empirical magnitude of some of these negative effects. He found that rate capping reduced aggregate Victorian employment by 7,425 jobs in the 2021/22 financial year. This comprised both local government jobs *per se* and indirect private sector positions. Moreover, rate pegging also reduced state gross income by \$890 million in 2021/22. Nahum (2021, p.5) concluded that ‘the costs of suppressed local government revenues, and corresponding austerity in the delivery of local government services, will continue to grow with each passing year if the policy is maintained’.

6. New South Wales Official Reports on Rate Pegging

Numerous official inquiries and reports have considered the impact of rate capping on local government in Australia. Given that NSW local government has had a rate cap continuously since 1977, unsurprisingly most of these official documents have focussed on rate capping in NSW local government. In section 6, we briefly consider recent important official reports and their findings on rate capping in NSW.

In May 2006, the Independent Inquiry into the Financial Sustainability of NSW Local Government published its *Are Councils Sustainable? Final Report: Findings and Recommendations* (sometimes known as the Allan Report) that was prepared for the (then) Local Government and Shires Associations of NSW (LGSA). The Allan Report (2006, p.29) adopted Recommendation 21: Rate Pegging which held that ‘the State Government free councils to determine their own income by removing statutory limitations on their rates (i.e. rate-pegging) and certain fees (e.g. development application processing fees) in return for councils adopting longer term strategic and financial planning with outcome targets’. The Allan Report (2006, p.29) argued that rate deregulation of this kind would ‘bring NSW into line with all other states and territories’ and make each local authority ‘answerable to its local constituency rather than the state for its taxation policy’.

In support of Recommendation 21, the Allan Report (2006, p.202) argued that ‘a sound local government rating system should ideally exhibit four traits; it should be financially adequate, administratively simple, vertically and horizontally equitable and economically efficient’. However, the Allan Report (2006, p.2007) argued that in NSW local government ‘rate-pegging had been a major constraint on councils’ revenue raising capacity causing it to fall behind other states, notwithstanding NSW’s relatively strong property market’. Consequently, in NSW the rating system did not deliver a financially adequate stream of income and hence numerous NSW local authorities could not sustainably finance service provision as well as local infrastructure maintenance and renewal.

In 2015, the NSW Government charged the Independent Pricing and Regulation Tribunal (IPART) with critically examining the municipal rating system in NSW and offering recommendations on how to improve the equity and efficiency of the rating system in order to enhance the financial sustainability of NSW local government in the long-run. IPART examined the valuation method used to calculate rates in NSW, exemptions and rating categories, the impact of population growth on council revenue, the distribution of rates across different ratepayers, as well as rate exemptions and concessions. IPART made various recommendations that sought to maintain average rates paid by current ratepayers, but make rate revenue collection more efficient and equitable.

In its 2016 *IPART Review of the Local Government Rating System: Final Report*, IPART offered various recommendations for improving the NSW local government rating system. These recommendations targeted six main aspects of the rating system. Firstly, IPART called for the adoption of the Capital Improved Value (CIV) valuation method to levy local council rates. Secondly, IPART recommended that the rate cap calculation methodology be modified to include population as part of its formula. Thirdly, IPART proposed that local authorities should be accorded greater flexibility in rate setting in their residential areas. Fourthly, IPART argued that rate exemption eligibility should be revised and based on land use rather than land ownership. Fifthly, IPART called for greater rate relief assistance for pensioners. Finally, IPART recommended that local councils enjoy a greater range of options with regard to setting rates within rating categories. These recommendations were designed to mesh with the existing *Local Government Act 1993 (NSW)*. Indeed, IPART specified in detail how changes to the Act should be framed to embody its recommendations.

In November 2020, the NSW Productivity Commission published its *Review of Infrastructure Contributions in New South Wales: Final Report*. The NSW Productivity Commission (2020, p.39) argued that in NSW ‘local government is constrained in its ability to service growing communities due to the long-standing practice of rate-pegging’, especially since the rate capping formula ‘does not allow councils to increase their rates revenue with population’. A consequence of this constraint has been ‘declining per capita revenue for high growth councils’ that has acted as a ‘disincentive for councils to accept development’. The NSW Productivity Commission (2020, p.39) argued that reform of the rate cap methodology was required to allow for the inclusion of population growth. It argued that rate cap reform along these lines would increase aggregate council revenue by \$18.5 billion over 20 years. This additional revenue could be employed to ‘fund local operating and maintenance costs of providing services to a growing population’, as well as ‘service debt to forward fund infrastructure’, thereby enabling local authorities ‘to better coordinate infrastructure with development’. It thus recommended that subject to review by IPART, the NSW Government should ‘reform the local government rate peg to allow councils’ general income to increase with population’.

In December 2020, the NSW Productivity Commission released its *Final Report: Evaluation of Infrastructure Contributions Reform in New South Wales* prepared by the Centre for International Economics. The *Final Report: Evaluation of Infrastructure Contributions Reform in New South Wales* (2020, p.2) held that there should be ‘reform of the local government rate peg to enable rates revenue to grow in line with population, removing the existing financial disincentive councils face with respect to growth’. The resultant growth in rates revenue would ‘enable councils to recoup the operating and maintenance costs associated with providing services to a larger population’. Moreover, ‘extra revenue can help service debt to forward fund infrastructure, improving the coordination of service delivery with development’.

The *Final Report: Evaluation of Infrastructure Contributions Reform in New South Wales* (2020, p.3) further argued that if this was done, then ‘we estimate that rates revenue would be around \$925 million per year higher’. This additional income could fund ‘the operating and maintenance costs of a growing population, to increase borrowing capacity and help finance debt’.

The *Final Report: Evaluation of Infrastructure Contributions Reform in New South Wales* (2020, p.51) argued that the impact of rate capping on NSW local government had been deleterious, particularly on local authorities with high population growth rates. This sub-category of council had experienced ‘slower growth in revenue per capita’, ‘slower growth in expenses per capita’ and ‘less improvement in their net operating balance’.

Flowing from the earlier reports by IPART and the NSW Productivity Commission, the NSW Government asked IPART to investigate methods of improving the NSW rate cap regime, including explicit incorporation of population growth. On 25 March 2021, IPART released *Issues Paper - Review of the rate peg to include population growth*, followed by its *Draft Report - IPART Review of the rate peg to include population growth* on 29 June 2021 and its *Final Report - Review of the rate peg to include population growth* on 5 October. In these reports, IPART developed a new methodology to enable local councils to maintain per capita general income over time as their local populations grew. This was done on the assumption that maintaining per capita general income would assist local councils to maintain existing service levels, as well as provide those local services their growing local communities required.

On 9 October 2021, (then) Minister for Local Government Shelley Hancock announced that the NSW Government had accepted IPART’s recommended rate peg methodology that incorporated population growth. She argued that the new methodology would generate at least \$250 million in additional municipal revenue (Hancock, 2021). The new rate peg calculation methodology would operate from July 2022 onwards.

7. IPART Rate Peg Methodology

In its *Review of the Rate Peg to include Population Growth: Final Report*, IPART (2021) outlined its new methodology and then applied it to each NSW local council for the 2022/23 financial year to determine the rate cap for each council. The new formula included a population factor that varied for each local council depending on its rate of population growth (IPART, 2021):

Rate peg=change in LGCI–productivity factor+other adjustments +population factor

The new formula employs four independent variables as the basis for calculating the annual rate cap for each council:

- (a) *Change in LGCI* comprises the annual change in the Local Government Cost Index (LGCI). The LGCI measures price changes over a given year for goods, materials and labour employed by an ‘average council’. In particular, the LGCI computes the average change in prices of a fixed 'basket' of goods and services used by councils relative to the prices of the same basket in a base period. The LGCI has 26 cost components, containing *inter alia* employee benefits and on-costs, as well as building materials for bridges, footpaths and roads. These cost components embody the purchases made by an average council to pursue its ‘typical activities’. IPART employs ABS price indexes for wage costs, producer prices and consumer prices. In calculating these price indexes, the ABS includes quality adjustments in its price measures to accommodate increases in capital and labour productivity.
- (b) *Productivity factor* is included in the formula since productivity increases offset changes in the LGCI. For example, if labour productivity rises, then this will decrease the net price of labour by the extent of the productivity increase. However, as we have seen, since the ABS price index data has already been adjusted for productivity, in practice IPART sets the productivity factor at zero in the formula.
- (c) *Other adjustments* is included in the formula to make provision any additional payments or transfers to local government that may have occurred. For instance, in its 2022/23 rate peg calculations IPART (2021, p.2) included a downward adjustment of 0.2% to remove the additional revenue that was included in the 2021-22 rate peg to meet the costs of the 2021 local government elections.
- (d) *Population factor* is calculated for each local council. The population factor is equal to the annual change in residential population adjusted for revenue derived from supplementary valuations. In particular, the population factor equals the maximum change in the residential population less the supplementary valuations percentage or zero. Local authorities with negative population growth receive a population factor of zero. This means that no local council accrues a smaller increase in general income, relative to a rate peg calculated using the LGCI, a productivity factor and any adjustments. Those local councils that accrued more from supplementary valuations than required to maintain per capita general income as their population grows will also have a population factor of zero. The population factor is computed employing the following formula: *Population factor = max(0, change in population – supplementary valuations percentage)*

The change in population is calculated using the *Estimated Residential Population* (ERP; emphasis added) published by the ABS.

IPART calculated the rate peg for the financial year 2022/23 using the new formula embodying LGCI change, a population factor and an adjustment to remove the costs of the 2021 local government elections that were included in the 2021-22 rate peg. This generated a 2022/23 rate peg for each NSW local authority at between 0.7% and 5.0%, contingent on its population factor. The population factor ranged between 0% and 4.3% (IPART, 2021, p.1).

8. Problems with the IPART Rate Peg Methodology

In addition to the myriad of conceptual and empirical problems with property tax limitations, such as the NSW rate capping regime, identified in the scholarly literature that we considered in sections 2, 3, 4 and 5 of this Report, several analysts have found significant flaws in the new IPART rate peg methodology with its population factor approach. In particular, while acknowledging that the introduction of different rate caps for different local councils represented a significant improvement in NSW rate pegging, Drew (2021; 2022) recognized three major problems with the new IPART rate cap formula.

Firstly, the use of population size in the IPART rate peg methodology is highly problematic for at least three reasons (Drew (2021; 2022)). Firstly, given the composition and range of services provided by NSW local councils, which concentrate on ‘services to property’ rather than ‘services to people’ (Dollery, Wallis and Allan, 2006), the number of rateable assessments in a given local government area is a much more accurate proxy variable for municipal size than absolute population size (Drew and Dollery, 2014). Secondly, it is universally recognized that population estimates of intercensal years contain significant errors, ranging from 2.4% in large councils to 15.6% in small local authorities (Drew, 2022). Thirdly, given the potential magnitudes involved, annual population changes can generate significant changes in rates under the IPART methodology, which can be highly destabilising to municipal financial planning. It follows that *if*¹ we incorporate a population factor into the rate cap, then it is best to employ a five-year moving average to reduce volatility and partially mitigate the large intercensal errors (given that censuses only take place every five years).

Secondly, the LGCI is plagued by a number of problems that render it entirely inappropriate as a reliable index of municipal costs. Drew (2022) has identified six main problems with the

¹ As we will show, there are much more appropriate ways of compensating councils for growth rather than by using a population number known to be both inaccurate and irrelevant.

LGCI. Firstly, the LGCI contains too few items and thus cannot accurately represent the typical ‘basket of goods and services’ purchased by NSW local councils. Secondly, given the fact that the composition of municipal input consumption changes over time, the weightings embodied in the LGCI should be calculated as a three-year moving average rather than a fixed ratio recalculated every four years (IPART, 2021). The current approach of altering the weightings is too infrequent and accordingly exacerbates volatility. Thirdly, given that the LGCI data employed to calculate rate caps in the forthcoming financial year reflects the previous annual price data, it is ‘rearward facing’. This is particularly problematic when cost inflation occurs, as it is at present with all the various supply shocks escalating prices. Fourthly, the LGCI represents a composite of cost indexes derived from different tiers of government - as IPART (2021) itself has conceded - rather than a cost index of NSW local government *per se*. Fifth, the LGCI has no regional weightings for NSW local government despite significant regional cost disparities across NSW (arising from the very disparate municipal service profile between various regions). Finally, the LGCI ignores the operating environment in which local authorities operate, even though this represents a major cost factor for local councils.

Finally, the IPART methodology for annual rate cap determination places two important categories of NSW local council at greater financial risk: rural local authorities and retirement community councils. For example, many rural councils have experienced ongoing population declines, together with an ageing population profile. This not only diminishes their rateable base, but also generates a higher proportion of pensioner rate rebates, which are not fully funded by NSW government grants (Dollery, Johnson and Byrnes, 2008). Similarly, for local councils with growing populations substantially comprised largely of retirees, like Port Stephens Council, a high proportion of older residents typically impose substantial additional service demands on local councils. A rate cap calculation formula that does not recognise the differential demands on different kinds of local council will thus place more councils at risk.

9. Twenty Questions in the IPART *Review of Rate Peg Methodology: Issues Paper*

Before embarking on the journey of answering IPART’s twenty questions, it is apposite that we first pose a question of our own:

What is the goal of the NSW Rate Cap regime?

Until IPART and the NSW Government are able to clearly articulate the basic aim of their rate cap regime, it is hard to believe that they will ever experience any success in achieving its unstipulated aim.

Official documentation implies various objectives, including: (a) reduced rates, (b) maintain financial sustainability, (c) simplicity and (d) accuracy. However, most of these implied goals contradict with one another. For instance, it is difficult to see how reducing rates might be expected to result in financial sustainability (without additional measures being implemented). In similar vein, it is clear that a myopic pursuit of simplicity must result in concomitant loss of accuracy (and hence also financial sustainability).

Thus, the most important question that ought to have been posed at the outset has been sadly eschewed and this will likely prove to be the Achilles heel of any review of the rate cap.

1. To what extent does the Local Government Cost Index reflect changes in councils' costs and inflation? Is there a better approach?

As we have seen in section 8 of this Report, the Local Government Cost Index (LGCI) is highly problematic and it is entirely inappropriate as a reliable index of municipal costs in NSW local government. Drew (2022) pinpointed six major deficiencies the IPART LGCI. In the first place, the LGCI comprises too few items and thus does not accurately depict the typical 'basket of goods and services' purchased by NSW local councils. Secondly, given the fact that the composition of municipal input purchases evolves through time, the weightings embodied in the LGCI should be calculated as a three-year moving average rather than a fixed ratio recalculated every four years (IPART, 2021). The present method of changing the weightings is too infrequent and thereby exacerbates the volatility of the LGCI. Thirdly, since the LGCI data employed to calculate rate caps in the forthcoming financial year reflects the previous annual price data, it is 'rearward facing'. This is particularly problematical when cost inflation arises, as it presently has, with various supply shocks escalating prices. Fourthly, the LGCI represents a composite of cost indexes derived from different tiers of government - as IPART (2021) itself has conceded - rather than a cost index of NSW local government *per se*. Fifth, the LGCI has no regional weightings for NSW local government despite significant regional cost disparities across NSW. Finally, the LGCI disregards the operating environment in which local authorities operate, even though this represents a major cost factor for local councils. In other words, the local government taxes in each council area are the price for quite disparate baskets of goods and services: it thus follows that changes to

these prices should vary in response to the different goods and services that make up the particular baskets.

A much better approach can easily be identified. As we have seen, the current LGCI employed by IPART is awash with problems that render it unsuitable as a basis for determining cost increases in operation of NSW local government. Given the spatial variation in municipal costs and municipal resource use across NSW, especially between metropolitan councils and their regional, rural and remote counterparts, Drew (2021) has argued that different cost indexes should be employed for – at a minimum – the four main categories of council (i.e. metropolitan, regional, rural and remote councils). The construction of these indexes should include the use of three-year moving averages of the mix and weighting of the basket of items in the index, a price increase projection for the forthcoming financial year and consideration of the operating environment of the four different categories of council. In particular, the environmental cost factor could be calculated in a precise manner by using econometric techniques on a three-year panel of socio-demographic data along with publicly available financial information. Moreover, using moving averages as suggested would considerably reduce volatility and thereby partially mitigate the problem whereby some local councils find it difficult to predict future rate caps for budgeting purposes.

It is also important to take into account the macro-economic challenges and trends that might face councils in the forthcoming financial year in determining the final rate cap. Put differently, the rate cap cannot entirely comprise an empirical exercise, since judgement must be exercised on future inflationary pressures.

2. What is the best way to measure changes in councils' costs and inflation, and how can this be done in a timely way?

As we have noted under question 1 above, much better approach exists. Given the geographical variation in municipal costs and municipal resource employment across NSW, particularly between metropolitan councils and their regional, rural and remote counterparts, Drew (2021) contended that different cost indexes should be employed for metropolitan, regional, rural and remote councils. These indexes should be constructed on the basis of three-year moving averages of the mix and weighting of the basket of items in the index, a price increase projection for the forthcoming financial year and an assessment of the operating environment of the four different types of council. Moreover, the environmental cost factor could be computed with precision by using econometric techniques and a three-

year panel of socio-demographic data together with publicly available financial information. Furthermore, employing moving averages would substantially reduce volatility and thereby partially mitigate the problem whereby some local councils find it difficult to predict future rate caps for budgeting purposes.

Moreover, if we are truly interested in accuracy then a number of changes to extant practice must follow. First, the rate cap needs to be issued far more precisely – to at least three decimal places – which would be reasonable given that it is multiplied through to millions of dollars of revenue². It is simply not acceptable to have material and avoidable rounding errors given that much more precise figures could easily be generated from index numbers and the like. Second, we need to use far more inputs to mitigate extant extreme synecdoche. We also need to use more precise inputs, rather than relying on known inaccurate proxies (such as wage price indexes³, CPI, or population estimates that we can be certain do not reflect actual costs). Third, this considerably expanded basket of goods and services purchased by local councils need to be re-priced at least annually and at a time more proximate to the use of the LGCI.

In addition, as we noted under question 1 above, it critical to consider the main macro-economic trends that might face local authorities in the forthcoming financial year in determining the final rate cap. In essence, the rate cap cannot entirely consist of an empirical exercise; judgement must be exercised on future inflationary pressures.

3. What alternate data sources could be used to measure the changes in council costs?

There is a wide range of actual and accurate data that ought to be used in place of the proxies that are currently heavily relied upon. This includes: (i) actual wage increase data for local government employees, (ii) actual auditing costs, (iii) actual audit committee costs, (iv) number of assessment data (that is both more closely related to the cost of local government provision and also far more accurate and timely), (iv) actual remuneration rulings for councillors, (v) the actual costs for hundreds of major items used by local governments on a regular basis, (vi) precise operating environment factors generated econometrically, (vi)

² Moreover, it would seem a relatively straight-forward matter to ensure that any rounding error in a given year was mitigated in the next year.

³ The use of the WPI is particularly perplexing given both the ease of using actual local government wage cost data and the size of this component (about a third of most NSW local council costs).

reevaluation adjustment data⁴, (vii) precise costs for holding elections and (viii) precise compliance costs.

4. Last year we included a population factor in our rate peg methodology. Do you have any feedback on how it is operating? What improvements could be made?

As we demonstrated in section 8 of this Report, the adoption of population size in the IPART rate peg methodology is highly problematical for three main reasons. In the first place, if we consider the mix of municipal services provided by NSW local authorities, which comprise mainly ‘services to property’ rather than ‘services to people’, the number of rateable assessments in a given local government area represents a much more accurate proxy variable for local government size than absolute population size, as demonstrated by Drew and Dollery (2014). Secondly, it is widely agreed that population estimates of intercensal years typically contain substantial errors, ranging from 2.4% in large councils to 15.6% in small local councils (Drew, 2022). Moreover, the ABS population data is often lagged by one or two years. Thus it is known to be inaccurate and irrelevant at the time of its use in the construction of the rate cap. Third, given the population magnitudes involved, annual population changes can produce significant changes in rates under the IPART methodology, which can be highly destabilising to local government financial planning. As we showed in section 8 of this Report, if we incorporate a population factor into the rate cap, then we should use a five-year moving average to reduce rate income volatility and partially alleviate the large intercensal errors (given that censuses only take place every five years).

The simplest and most effective way to compensate councils for growth in the local government area – consistent with one of the stated goals of the rate cap (to reduce pressure on the tax liability for the average ratepayer) – is to apply the cap to the average rate for each of the categories. As we have already described in previous submissions, this automatically adjusts for growth in a way that uses reliable and timely data (number of assessments⁵). It also has the benefit of discouraging the use of minimum and base rates that are clearly contrary to another purported goal of the rate cap (distributive justice (Drew (2021))).

⁴ The aggressive revaluation of assets by the Auditor-General is significantly affecting the income statements of Councils – if we want local governments to aspire to balanced budgets then these costs ought to be recognised (because it can’t be reliably assumed that previous rate caps recognised the costs of these long-lived assets in earlier periods of cost-allocation).

⁵ Notably organic growth (for instance births in an existing household) exert very limited cost pressures on councils compared to the subdivision of properties and establishment of new developments. Thus, responding to new assessments is likely to be much more important than responding to additional people.

However, the fact remains that a factor for growth disadvantages most rural and remote communities in a relative sense. These rural and remote councils are the most financially unsustainable category of local governments in NSW. Thus, a factor to compensate for operating environment (as we outlined earlier) is an absolutely essential element of any new rate cap methodology if we are to avoid further financial collapses in NSW local government.

5. How can the rate peg methodology best reflect improvements in productivity and the efficient delivery of services by councils?

If the NSW Government wishes to reflect improvements to efficiency and productivity, then it will be necessary to first accurately measure these constructs. Extant measures – such as operational expenditure per capita – are woefully inadequate as proxies for efficiency (Drew and Dollery, 2015). Instead, intertemporal data envelopment analysis (with appropriate adjustments) would need to be employed. Moreover, it would be essential to have an annual consistent survey of citizen satisfaction (or another reliable proxy for service quality) to ensure that supposed efficiencies were indeed the case (rather than merely reductions to service quality).

However, there is significant potential that policy adjustments to reflect efficiency would have serious, undesirable and unintended consequences. First, it would entirely remove the incentive for local councils to improve efficiency, because doing so would reduce their revenue. Accordingly, an efficiency dividend could well run contrary to the long-run interests of ratepayers. Second, it would further exacerbate the financial sustainability crisis that already grips around two-thirds of NSW local councils. At present, most councils actively seek out efficiencies as a way to partially-mitigate perceived inadequacies in rate cap dictates. If IPART or the NSW Government were to reduce the rate cap according to efficiencies achieved, then this would likely bring forward the time for a looming local government financial crises.

Most councils in NSW are active in pursuing efficiencies to try to maintain a semblance of financial sustainability. It would thus be a grave mistake to do anything to dissuade or punish them for these efforts (especially if we were to use inaccurate measures of efficiency as is currently the case).

6. What other external factors should the rate peg methodology make adjustments for? How should this be done?

As we have noted earlier, any rate peg calculation method must embody ‘forward facing’ elements, especially with respect to inflationary pressures. This means *inter alia* that the computation of the rate cap will embody forecasts of future cost increases and price rises that NSW local councils will experience. As we have suggested under section 10 of this Report, a rate cap setting panel should be established comprising *bona fide* experts on local government economics who can offer informed judgements on future cost increases and price rises in NSW local government.

Moreover, as the RBA (Lowe, 2021) has graphically illustrated in recent times, making predictions regarding likely inflation outcomes is thwart with danger. For this reason, it is essential that our recommendation for a rate cap range, made in earlier submissions, be adopted. Specifically, offering councils a rate cap range reflective of the uncertainty in both future predictions and past data⁶ allows local decision-makers to better tailor their tax increases to their local knowledge regarding the specific challenges emerging in their council area. It also improves democratic accountability and reduces the problem of learned helplessness that has been noted in the literature (Drew, 2021).

7. Has the rate peg protected ratepayers from unnecessary rate increases?

In the short-run a rate peg might protect ratepayers from increases to their tax liability. However, this protection currently comes at significant costs especially to the most vulnerable in the community.

What typically occurs is that councils delay required tax increases because of the expense and political controversy likely to be engendered by a Special Rate Variation (SRV). However, ultimately matters come to a crisis point and then ratepayers are confronted with an extraordinarily large rate increase. It is not hard to find evidence of hefty local rate increases in the IPART determinations, such as 94.787% for Balranald in 2018-19 and 53.5% for Cootamundra-Gundagai in 2021-22. Indeed, there are dozens of SRVs of thirty percent or more. It is hard to believe that residents in these areas would agree that the rate cap saved them from unnecessary rate increases! It is much more likely that they would contend that the rate cap merely spared them a little bit of pain over many years that metastasized into a great burden later because it had been left un-checked.

⁶ Able to be precisely quantified using relatively rudimentary statistical measures.

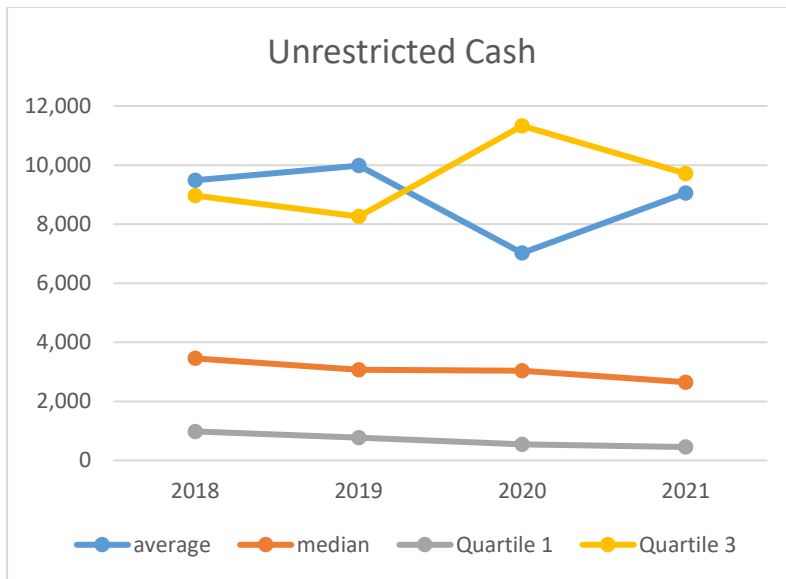
Moreover, deferral of needed rate increases, which is a prominent feature of the rate cap regime, also presents significant intergenerational equity risks. This occurs because existing residents may avoid needed rate increases for a decade or more which are ultimately forced onto contemporary ratepayers who may not have been beneficiaries of past expenditure (for instance if they only recently became homeowners in the local government area).

Furthermore, large and unexpected SRVs needed to mitigate inadequate rate caps over many years tend to disproportionately hurt the most disadvantaged in our communities. These people are the least likely to have savings to draw on to mitigate unexpected rate shocks that accompany SRVs. In addition, the services most likely to be cut by councils to cope with constraints on rate revenue tend to be discretionary projects such as programs tailored to the aged, unemployed, disabled or culturally diverse groups. This is the stark consequence of less-than-competent execution of seeking to reduce ‘unnecessary’ tax increases.

For all these reasons, in our previous work, we have strongly advocated for automatic triggers linked to a competent financial sustainability monitoring system (which sadly is not our current system). Automatic triggers would force councils to apply for a SRV when data demonstrated that financial sustainability had waned significantly, thus avoiding inappropriate delays to adjust rates which ultimately result in unacceptable large rate shocks.

8. Has the rate peg provided councils with sufficient income to deliver services to their communities?

Financial failures in NSW local government, together with dwindling cash reserves (that have now reached critical levels for median and quartile 1 councils) clearly demonstrate that the rate peg has not delivered sufficient income for councils and their communities. Indeed, frequent approvals of hefty SRVs to address ‘financial sustainability’ submissions to the IPART, also underline the inadequacy of current practice.



It is unlikely that a ‘one-size-fits-all’ rate cap will ever be able to provide the disparate NSW cohort of councils and communities with sufficient income to deliver needed services. In accordance with the decentralization theorem, each council provides a different set of goods and services tailored to the particular tastes and preferences of their citizens. This is the whole point of decentralized local government. Furthermore, each community faces different challenges, operating and economic environments. Thus, it follows that each local council needs the flexibility to set the particular rate of the increase to their specific basket of goods provided according to their superior local appreciation of local conditions. This can best be achieved by providing a short range of rate cap for each major category of local government and trusting the democratic accountability and high professionalism of local government decision-makers to make appropriate decisions about the precise price rise required for their specific councils.

9. How has the rate peg impacted the financial performance and sustainability of councils?

As we have seen in section 5 of this Report, Dollery and McQuestin (2017) empirically investigated the likely effects of a rate cap on South Australian (SA) local government by comparing the performance of SA local government with NSW local government employing three performance indicators (revenue effort, financial sustainability and operational efficiency) over the period 2013 to 2016. Dollery and McQuestin (2017, p.84) established that ‘rate-capping in NSW has not served to reduce inter-municipal revenue effort inequities’. Moreover, rate capping is thus ‘most unlikely to minimise these inequities in SA local government’. In addition, Dollery and McQuestin (2017) found that the ‘claims made by proponents of rate-pegging that it improved financial sustainability’ were falsified by their

findings. For example, comparing council debt per capita as a proxy for financial sustainability, Dollery and McQuestin (2017) found that ‘NSW local authorities have much higher debt than their SA counterparts despite the four decade long rate-pegging regime in NSW’. Furthermore, Dollery and McQuestin (2017, p.84) established that the operational efficiency of local councils did not increase under rate capping. Using council expenditure per capita as a measure of the operational efficiency of local councils, Dollery and McQuestin (2017, p.84) demonstrated that ‘rate-pegging does not increase the efficiency of local councils: for each year in our sample, the efficiency of NSW councils falls well below SA councils’.

In sum, Dollery and McQuestin (2017, p.84) found that ‘on all three dimensions of local government examined in our empirical analysis, we find SA councils performance better than NSW local government notwithstanding the latter’s longstanding rate-pegging policy’. Furthermore, compared to NSW, ‘SA municipalities exhibit superior performance’. In light of their findings, Dollery and McQuestin (2017, p.84) concluded that ‘the empirical evidence presented in the paper demonstrates that rate-pegging should not be imposed on SA local government and instead other more promising policies [should be] considered’.

10. In what ways could the rate peg methodology better reflect how councils differ from each other?

Following from our observations under question 1 above on regional variations in the LGCI, different rate caps should be calculated for councils falling in (at least) the four main municipal categories in NSW local government (metropolitan, regional, rural and remote councils). This will not only more accurately reflect the different operating environments facing these categories of council, but also facilitate comparisons between the performance of local councils in each category. As a consequence, there will be greater transparency for local residents and more accountability for local councillors.

As noted in this Report as well as in our earlier submission, the rate cap should also be provided as a range for these four main categories of councils. This will allow local government decision-makers to use their superior knowledge of local conditions to set a precise price increase for the basket of goods and services that best reflects their community’s specific needs and circumstances. It will also promote democratic accountability and combat learned helplessness.

People outside of Sydney rarely understand the importance of rural councils having the flexibility to tax at higher rates in good agricultural seasons to build up reserves against local economic shocks arising from poor agricultural seasons at other times. Rural economies are very dependent on weather conditions, as well as commodity prices, and a failure to provide the flexibility to properly respond to prevailing conditions has caused much harm to rural communities. Accordingly, a flexible range of rate caps is especially important in rural areas.

11. What are the benefits of introducing different cost indexes for different council types?

As we have observed, given the spatial variation in municipal costs and municipal resource use across NSW local government, especially between metropolitan councils and their regional, rural and remote counterparts, Drew (2021) and others have argued that different cost indexes should be employed for (at a minimum) four main categories of council (metropolitan, regional, rural and remote councils). The construction of these indexes should include the use of three-year moving averages of the mix and weighting of the basket of items in the index, a price increase projection for the forthcoming financial year and consideration of the operating environment of the four different categories of council. In essence, using moving averages as suggested would considerably reduce volatility and thereby partially mitigate the problem whereby some local governments find it difficult to predict future caps for budgeting purposes.

However, if we truly wished a rate cap to be responsive to the particular needs and circumstances of different communities then it would either be: (a) necessary to have a much more carefully assembled LGCI constructed for each individual council, or (b) a rate cap range provided to each category of local government so that relevant decision-makers might use their superior local knowledge of the precise circumstances faced by their communities to set an appropriate price increase.

12. Is volatility in the rate peg a problem? How could it be stabilized?

A certain degree of volatility in the rate cap is to be expected. However, what is problematic is when the volatility is *unanticipated* and out of line with official Australian Bureau of Statistics (ABS) CPI and PPI data. Put differently, it is the volatility between the expected rate cap and the actual rate cap proclaimed that is the real problem for local government. Indeed, current instructions for councils to assume a rate cap of 2.5% (which does not seem to have changed for well over a decade) should be reviewed far more regularly to avoid significant errors creeping into LTFP and thereby exposing communities to fiscal risk.

As we have already detailed, the rate cap can be stabilized by using moving averages. However, it is also important that far more up-to-date data is used in the calculation of the rate cap. Moreover, the gap between expected rate cap and actual rate cap can be redressed by also considering forward-looking indicators when determining the rate, as well as issuing a final cap at a time much closer to when councils might reasonably be expected to be incorporating it into their decision making (i.e. March-May each financial year). In this regard it would seem prudent to provide an indicative rate cap early on for the drafting of budgets, but only proclaim the final rate cap proximate to its final use.

13. Would councils prefer more certainty about the future rate peg, or better alignment with changes in costs?

It should go without saying that local councils and local communities alike would prefer a rate cap that was accurate and adequately met the demands of financial sustainability. Certainty that the rate cap would be appropriate and responsive to actual economic conditions is much preferred to certainty about it being a particular number. At present, there is little confidence in the NSW local government community that future rate caps will be appropriate for the economic conditions that actually prevail at the relevant time. This represents a substantial problem that IPART and the NSW government must respond to.

14. Are there benefits in setting a longer term rate peg, say over multiple years?

Given that the RBA informed us in November 2021 that inflation would be transitory (Lowe, 2021), it is hard to imagine how IPART might think that an accurate long-term rate cap could possibly be divined. As we have already stressed, it is not certainty in a particular number that is at stake here. Rather local councils simply need to be certain that the rate cap will be appropriate for the specific conditions that they face at the relevant time.

15. Should the rate peg be released later in the year if this reduced the lag?

As we have already outlined, an indicative rate cap should be released at around the same time as occurs at present to assist with forward budgeting. However, the final rate cap should certainly be proclaimed as late as practical (i.e. April-May each financial year) in order to ensure that it is sufficiently responsive to prevailing macro-economic conditions. This is particularly important in a high inflation environment where macro-economic forces are volatile and unpredictable. Indeed, had this practice been adopted in the past, local councils

and local communities would have been spared the unnecessary cost and time involved in the recent ASV.

16. How should we account for the change in efficient labour costs?

As we detailed in our response to question 5 it would be a grave mistake to penalize councils for efficiency improvements. First, it would be necessary to measure efficiency correctly (which is presently not done owing to methodological and data problems). Second, it would likely result in deleterious unanticipated consequences.

17. Should external costs be reflected in the rate peg methodology and if so, how?

It is not quite clear what IPART means by ‘external costs’. However, certainly all costs must be considered as part of the compilation of a competent rate cap.

At present it appears that many important costs are not considered, such as new compliance costs (like the ARIC committees and the significantly higher audit costs after central auditing), cost-shifting and aggressive revaluations of existing assets pursued by auditors (that should have been reflected in past rate caps but certainly have a large bearing on current bottom lines).

Moreover, sensible adjustments need to be made to the permissible general income calculation to account for the portion of the pensioner rebates *not* refunded by the NSW Government (i.e. the notional general income should be increased by the amount of the rebates *not* received back as a subsidy). This simple change would mean that rural and fringe councils, which are often in the most precarious financial position, would no longer be penalised by the higher and increasing proportion of pensioners that choose to live in their areas.

In addition to calculating the rate cap so as to minimise uncertainty and reduce income volatility, it is also important to take into account the macro-economic challenges and trends that might face councils in the forthcoming financial year(s) under the stipulated rate cap. Put differently, the rate cap cannot be a purely empirical exercise; judgements must also be made about future inflationary pressures and other external forces that will impinge upon council costs.

18. Are council-specific adjustments for external costs needed, and if so, how could this be achieved? Please see our response to question 17.

19. What types of costs which are outside councils' control should be included in the rate peg methodology?

As detailed in our response to previous questions, adjustments must be made for a range of compliance, audit revaluation, cost-shifting and pensioner-discount costs. Indeed, adjustments should have been made for the substantial direct and indirect costs associated with COVID requirements and it would be appropriate to include a catch-up factor for this in the next rate cap.

Given the problem with sourcing appropriately trained staff, especially in rural and remote areas, it would also be appropriate to adjust rate caps for staff training and relocation expenses (or alternatively these costs could be reflected in the notional general income calculation).

In addition, it is absolutely essential that costs associated with local economic shocks are reflected in rates. This is particularly important in rural areas where climatic conditions and changes to commodity prices can have large effects on both 'capacity to pay' and 'need' for local government services (and hardship provisions).

As we have suggested a number of times, a rate cap range will often be the best way to reflect external costs that are specific to particular councils. Often it would not be possible for IPART to understand or quantify the myriad of specific external costs faced by various local communities at particular times. We need to trust to the superior local knowledge of local decision-makers to do so. Moreover, the democratic process has a built-in accountability mechanism to ensure that a rate cap range would not be exploited (although we note that simple reporting by IPART, along with pre-election fiscal statements long championed by scholars such as Drew (2021), could also act as an effective check on opportunistic behavior).

20. How can we simplify the rate peg calculation and ensure it reflects, as far as possible, inflation and changes in costs of providing services?

As we laid bare at the outset, a competent rate cap needs to have a clearly articulated purpose. We do not believe that simplicity ought to be the primary purpose of a rate cap. Indeed, most of the inaccuracy and subsequent fiscal damage caused by the rate cap has come about because of a desire to make things simple (often through the inappropriate use of indexes).

The costs of getting rate caps wrong are substantial, both in terms of financial sustainability as well as the broader social costs to the most vulnerable in our communities. We suspect that simplicity is a goal motivated in part by the desire to keep IPART/NSW government costs down. However, there is clearly a multiplier effect on the costs of inaccurate rate caps. Thus, it should be clear that the prudent course of action would be to invest more adequately in an accurate rate cap, better tailored to the needs of particular communities. To borrow a phrase from Bird et al. (2015): ‘to buy cheap methodology is to buy dear in the longer term’.

10. Recommendations

In this Report, we have (a) considered the major arguments in the ongoing debate in NSW local government over the impact of rate capping; (b) we examined the various theoretical considerations on the nature of property tax limitations and their regulation; (c) we surveyed the international empirical literature on the impact of property tax limitations; (d) we discussed the Australian empirical literature on the impact of rate pegging in local government; (e) we considered the findings of recent inquiries and official reports on rate capping in NSW local government; (f) we outlined the new IPART methodology for calculating the annual rate cap that includes a population growth factor; (g) we examined various problems inherent in the IPART methodology; and (h) we provided answers to the twenty questions provided by IPART (2022) in its *Issues Paper*. We now offer several recommendations for improving the municipal rating system in NSW local government.

As we have demonstrated in this Report, the longstanding rate cap regime in NSW local government has had a damaging impact on municipal performance, especially the continuing inadequacy of income from rates, related ongoing problems with the financial sustainability of NSW local government and associated inadequate infrastructure maintenance and renewal (Dollery, Johnson and Crase, 2006). Moreover, as we have shown in the Report, the new IPART rate cap methodology is seriously deficient and it will accordingly further damage the financial sustainability of NSW local government (Drew 2021; 2022).

Two alternative generic approaches of improving the NSW local government rating system exist:

RECOMMENDATION 1: ‘FIRST-BEST’ APPROACH ABOLISH RATE CAPPING

A ‘first-best’ approach would be for the NSW Government to simply abolish rate pegging and grant local councils the freedom to strike their own rates and be held accountable by their

own local residents. As we have demonstrated in this Report, this approach accords with both economic theory on optimal municipal property taxation and local democratic accountability, as well as the weight of international and Australian empirical evidence on property tax limitations.

However, this optimal approach involving the abolition of the rate cap in NSW local government faces the harsh political reality that it is politically extremely difficult to remove rate pegging from NSW local government. In this regard, Drew (2021, p.111) observed that ‘no political party is likely to voluntarily remove existing tax limitation regimes because there is a considerable risk that taxes would be increased soon after, and the party facilitating this would be greeted with the displeasure of voters at the next higher tier election’.

Moreover, ‘because taxation limitations are a politically popular way of responding to cost of living pressures – at no immediate cost to the instigator – their incidence is only likely to increase in future’.

RECOMMENDATION 2: ‘SECOND-BEST’ APPROACH REDESIGN RATE CAPPING

A ‘second-best’ pragmatic approach must accept that rate capping will remain an unassailable feature of NSW local government, regardless of the political complexion of the state government. We thus contend that reform should instead focus on removing the worst features of the NSW local government rate pegging regime. Put differently, a ‘second-best’ approach should concentrate on improving the IPART rate cap methodology.

Drew (2021, pp.111-114; 2022) has advanced several recommendations for reforming rate caps which we have augmented with additional suggestions. Firstly, as noted earlier, we recommend different cost indexes be employed for metropolitan, regional, rural and remote councils. As we have seen, the current LGCI employed by IPART is awash with problems that render it unsuitable as a basis for determining cost increases in operation of NSW local government. Given the spatial variation in municipal costs and municipal resource use across NSW, especially between metropolitan councils and their regional, rural and remote counterparts, Drew (2021) argues that different cost indexes should be employed for – at a minimum – the four main categories of council (metropolitan, regional, rural and remote councils). The construction of these indexes should include the use of three-year moving averages of the mix and weighting of the basket of items in the index, a price increase projection for the forthcoming financial year and consideration of the operating environment

of the four different categories of council. In essence, using moving averages as suggested would considerably reduce volatility and thereby partially mitigate the problem whereby some local governments find it difficult to predict future caps for budgeting purposes.

It is also important to take into account the macro-economic challenges and trends that might face councils in the next year when determining the final cap. Put differently, the rate cap cannot be a purely empirical exercise; judgements must also be made about future inflationary pressures and the like.

Secondly – and following from our first recommendation - we contend that different rate caps be calculated for councils falling in the four main municipal categories in NSW local government (metropolitan, regional, rural and remote councils). This will not only more accurately reflect the different operating environments facing these categories of council, but it will also facilitate comparisons between local council outcomes in each category. Accordingly, there will be greater transparency for local residents and more accountability for local councillors.

Thirdly, we recommend that a rate cap setting panel, as well as the SRV assessment panel, should include at least one scholarly local government expert. Scholarly knowledge of rate cap theory and sophisticated empirical techniques are clearly important for the development of a sound cap. Moreover, scholars are perceived to have greater independence (thus strengthening perceptions for a range of rate cap stakeholders) and can bring new insights to deliberations. Many of the problems associated with the recent changes would have been avoided if a suitably credentialed person was on the deliberative panels. It is thus wise to address this gap to avoid problems in the future.

Fourthly, we recommend that the rate cap should be based on the average rate for each category of property. As we have seen, the IPART rate cap methodology calculates the annual rate cap for each council based on its total property tax revenue from the previous financial year. Changing to a calculation based on typical (mean) rate impost will have significant benefits for local authorities. For instance, it will mean that the construction of new dwellings and businesses in a given local government area will increase the total tax intake. This will better enable local councils to absorb the costs of growth, including the need for additional local infrastructure investment. It would also mean that the inaccurate and controversial population growth factor would be rendered redundant.

To calculate the cap, the average of each category (from the previous period) would need to be inflated by the specific cap for the particular type of council, then multiplied by the number of assessments in the given category as at the most recent record date. The total tax take would then be equal to the sum of the various category calculations.

A rate cap based on the averages for each category will also encourage more prudent use of minimum rates and base rates. This implies that it will thus contribute to greater distributive justice. Furthermore, an approach based on averages is more consistent with the objectives of a rate cap; that is, to avoid rate shock for the typical resident. By setting rate caps on the foundation of the typical rate imposed on each category of ratepayer we are much more likely to avoid rate shock for the typical ratepayer.

Fifthly, we recommend that the rate cap should be provided within a small range rather than as a single set number. A rate cap should not be a single figure for each council, but instead encompass a small range of potential rate increases (thus, for instance, a rate cap can be expressed as 2.4 to 3.0% rather than simply 2.7%). This would have a number of advantages. Firstly, it would diminish much of the ‘learned helplessness’ and ‘blame shifting’ inherent in the current rate cap regime. Second, it would enable councillors to lessen any error in the calculation or calculation methodology. Third, it would allow for local councils to adjust to changes in conditions that occur in the long time-span between promulgation of the rate cap and the start of the new financial year. Fourth, it would empower regulators to explicitly include the statistical error term associated with any empirical calculation. Fifth, it would reassert democratic accountability and would give councillors greater opportunity to respond to community circumstances and community preferences. A rate cap incorporating a small range would still reduce the potential for monopolistic excesses, but it would do so in a manner that respects both the uncertainty of the rate cap construction as well as local democratic principles.

Sixthly, we recommend more sensible timelines should be established for SRV nominations and applications. The current timeline for SRVs in NSW could hardly be worse and contribute to a range of avoidable costs (see Table 1 below). In practice, it often means that local councils are breaking bad news to their local communities immediately prior to Christmas. In the most recent year of delayed elections, the early nomination date meant that

many councils delayed their SRV by an additional year which may well have caused serious financial sustainability problems. Moreover, it increases stress on council staff who often have to give up customary extended periods of leave typically taken over the festive season. In addition, it adds to consultant costs because companies are often forced to pay premiums to staff to work over the festive season.

In Victoria much more reasonable date are employed, as we can see from Table 1. Intent to apply is purely optional, as it should be. Moreover, the applications roll in over a long period which allows for much better assessment turnaround times. In addition, it also makes it much more likely that applications get assessed on their own merits rather than being sub-consciously compared to other applications.

Table 1: Special Rate Variation Key Dates for NSW and Victoria

Event	NSW Date	Victorian Date	Recommendation
Notification of Intent to apply for a SRV	26 November	31 January*	End of January (optional)
SRV application due date	7 February	1 February until 31 March	Should be submitted any time prior to mid-April
Determinations announced	May 2022	Within two months of receiving the application	Within six weeks of application

* Note this is only an option in Victoria. It is not mandatory to give notice of intent.

Our seventh recommendation suggests automatic triggers should be employed. One of the significant problems associated with a rate cap regime is that it is associated with steep political costs. This explains why many local councils are hesitant to indicate intent to apply for an SRV in election years. The problem with delaying SRVs is that a council may fail financially in the interim. Moreover, it also tends to mean that increases need to be higher to make up for foregone rate revenue for the year(s) deferred.

Political costs could be reduced substantially by making SRVs mandatory when certain triggers are met. This would indicate that the local community in question would perceive the SRV as an act required from fiscal prudence rather than political choice. It would also mean

that the rate cap regime would not add further to the already deplorable record of local government financial failures in the NSW local government system (Drew et al., 2021).

Triggers should include standard ratios already in use. However, they would require the NSW OLG to employ more reasonable benchmarks based on empirical evidence (rather than the current apparently arbitrary numbers). In particular, the following ratios represent excellent candidates:

- Operating ratio (over *three* years)
- Unrestricted Current ratio (with a more appropriate benchmark)
- Debt ratio (with more suitable benchmark)
- Cash expense ratio (using a more appropriate benchmark)
- Rates outstanding (currently there is no benchmark and it should be noted that a ceiling - rather than a floor - would be most appropriate here to protect ratepayers).

We have specifically excluded the asset maintenance ratios because they are typically too unreliable at present. Moreover, their use may exacerbate the already high levels of distortion to these numbers.

Regulators might also consider introducing a trigger whereby a certain turnover in councillors following elections would establish a presumption that a new rating policy should be constructed, where a new rating policy might result in a reduction to total tax take, different categories, changes to minimum and base rates and hence greater distributive justice (Drew, 2021). This would be consistent with calls for greater political accountability with respect to municipal finance.

In addition, given the extreme fiscal distress currently experienced by forcibly amalgamated councils as a result of the disastrous NSW local government *Fit for the Future Program* (Drew et al., 2021), it should be considered essential that all compulsorily consolidated councils submit an SRV application as a matter of urgency.

Our eighth and final recommendation prescribes that the burden of proof should rest with the assessing panel or those who object to the proposed rate cap to offer sound reasons for why it should be rejected or reduced. Given that SRV applications are publicly available, and should also be based on thorough and robust proof of need according to prescribed criteria, the burden of proof should rest with the SRV assessment panel or those who object to the proposal to provide compelling reasons for why the SRV should be rejected or reduced. This

is especially the case when local councils have availed themselves of suitably qualified experts to assist in the preparation of the SRV and where they have provided robust empirical evidence in support their claims. In essence, reversing the burden of proof along the lines we suggest would more appropriately respect the efforts of council staff and the deliberations of politically accountable councillors.

References

- Anderson, N. (2006), 'Property tax limitations: An interpretive review', *National Tax Journal*, 59 (3), 685–694.
- Bailey, S. J. (1999), *Local Government Economics: Principles and Practice*, Macmillan, London.
- Bird, S., D. Cox, V. Farewell, H. Goldstein, T. Holt and P. Smith. 2005. 'Performance Indicators: Good, Bad, and Ugly'. *Journal of Royal Statistical Society* 168(1):1–27.
- Blom-Hansen, J., Baekgaard, M., Serritzlew, S. (2014), 'Tax limitations and revenue shifting strategies in local government', *Public Budgeting and Finance*, 64–84.
- Boadway, R. and Shah, A., (2009), *Fiscal Federalism: Principles and Practice of Multi-Order Governance*, Cambridge University Press, London.
- Bos, D. (1994), *Pricing and Price Regulation*, Elsevier North Holland, Amsterdam.
- Brown, T., (2000), 'Constitutional tax and expenditure limitation in Colorado: The impact on municipal governments', *Public Budgeting and Finance*, 20 (3), 29–50.
- Cutler, D., Elmendorf, D. and Zeckhauser, R., (1999), 'Restraining the Leviathan: Property tax limitation in Massachusetts', *Journal of Public Economics*, 71, 313–334.
- Dollery, B. E., Crase, L. and Johnson, A. K. (2006), *Australian Local Government Economics*, UNSW Press, Sydney.
- Dollery, B.E. and Drew, J.D. (2016), 'An assessment of the New South Wales Government's post-amalgamation rate path freeze policy', *Journal of Australian Taxation*, 18, 143–162.
- Dollery, B. E. and McQuestin, D. (2017), 'No Panacea: Rate-Capping in South Australian Local Government', *Economic Analysis and Policy*, 56(4), 79-85.
- Dollery, B. E., Wallis, J. L. and Allan, P. (2006), 'The Debate That Had to Happen But Never Did: The Changing Role of Australian Local Government', *Australian Journal of Political Science*, 41(4), 553-567.
- Dollery, B. E. and Wijeweera, A. (2010), 'Time for Change? An Assessment of Rate-Pegging in New South Wales Local Government', *Commonwealth Journal of Local Governance*, 6, 56-76.
- Drew, J. and Dollery, B.E. (2015), 'Careful what you wish for: Rate-capping in Victorian local government', *Journal of Australian Taxation*, 17 (1), 139–163.

- Figlio, D. and O’Sullivan, A., (2001), ‘The local response to tax limitation measures: Do local government manipulate voters to increase revenues?’ *Journal of Law and Economics*, 44 (1), 233–257.
- Florestano, P., (1981), ‘Revenue-raising limitations on local government: A focus on alternative responses’, *Public Administration Review*, 41, 122–131.
- Hillman, A. L. (2005), *Public Finance and Public Policy*, Cambridge University Press, Cambridge.
- Independent Pricing and Regulatory Tribunal (IPART) (2008), *Revenue Framework for Local Government: Issues Paper*, IPART, Sydney.
- Independent Pricing and Regulatory Tribunal (IPART) (2016), *IPART Review of the Local Government Rating System: Final Report*, IPART, Sydney.
- Independent Pricing and Regulatory Tribunal (IPART) (2016), *IPART Review of the Local Government Rating System: Government Response*, IPART, Sydney.
- Independent Pricing and Regulatory Tribunal (IPART) (2021), *Issues Paper - Review of the rate peg to include population growth*, IPART, Sydney.
- Independent Pricing and Regulatory Tribunal (IPART) (2021), *Draft Report - IPART Review of the Rate Peg to include Population Growth*, IPART, Sydney.
- Independent Pricing and Regulatory Tribunal (IPART) (2021), *Review of the Rate Peg to include Population Growth: Final Report*, IPART, Sydney.
- Independent Pricing and Regulatory Tribunal (IPART) (2022), *Review of Rate Peg Methodology: Issues Paper*, IPART, Sydney.
- Jensen, M. and Meckling, W. (1976), ‘Theory of the firm: Managerial behaviour, agency costs and ownership structure’, *Journal of Financial Economics*, 3(4), 305–360.
- Johnson, A. K. (2001), *Beyond the Three R’s: Financing Local Government*, Centre for Local Government, University of New England.
- Kousser, T., McCubbins, M., and Moule, E. (2008), ‘For whom the bell tolls: Can state tax and expenditure limits effectively reduce spending?’ *State Politics and Policy Quarterly*, 331–361.
- Local Government and Shires Associations of NSW (2008), *Submission to the Independent Pricing and Regulatory Tribunal of NSW’s Review of Revenue Framework for Local Government*, Local Government and Shires Associations of NSW, Sydney.
- Lowe, P. (2021). Recent Trends in Inflation. RBA. Accessed 7th October, 2022. Available at: <https://www.rba.gov.au/speeches/2021/sp-gov-2021-11-16.html>
- McCubbins, M. and Moule, E. (2010), ‘Making mountains of debt out of molehills: The pro-cyclical implications of tax and expenditure limitations’, *National Tax Journal*, 63(3), 603–621.

- Mullins, D. (2004), 'Tax and expenditure limitations and the fiscal response of local government: Asymmetric intra-local fiscal effects', *Public Budgeting and Finance*, 24(4), 111–147.
- 75–101.
- Mullins, D. and Joyce, P. (1996), 'Tax and expenditure limitations and state and local fiscal structure: An empirical assessment', *Public Budgeting and Finance*, 16 (1), 75–101.
- Mullins, D. and Wallin, B. (2004), 'Tax and expenditure limitation: Introduction and overview', *Public Budgeting and Finance*, 24 (4), 2–15.
- Nahum, D. (2021), *Putting a Cap on Community: The economic and social consequences of Victoria's local government rate caps policy*. Centre for Future Work, Melbourne.
- NSW Government (2020), *IPART Review of the Local Government Rating System: Final Response*. Office of Local Government, Sydney.
- NSW Productivity Commission (2020), *Review of Infrastructure Contributions in New South Wales: Final Report*, NSW Productivity Commission, Sydney.
- NSW Productivity Commission (2020), *Final Report: Evaluation of infrastructure contributions reform in New South Wales*, NSW Productivity Commission, Sydney.
- NSW Treasury (2008), *Submission to the NSW Independent Pricing and Regulatory Tribunal*, NSW Treasury, Sydney.
- Preston, A. and Ichniowski, C. (1991), 'A national perspective on the nature and effects of the local property tax revolt, 1976–1966', *National Tax Journal*, 44 (2), 123–145.
- PriceWaterhouseCoopers (2006), *National Financial Sustainability Study of Local Government*, Australian Local Government Association, Canberra.
- Shadbegian, R., 1999. The effect of tax and expenditure limitation on the revenue structure of local government, 1962–87. *Natl. Tax J.* 55 (2), 221–237.
- Skidmore, M., 1999. Tax and expenditure limitations and the fiscal relationships between state and local governments. *Public Choice* 99 (1/2), 77–102.
- Temple, J. (1996), 'Community composition and voter support for tax limitations: Evidence from home-rule elections', *Southern Economic Journal*, 62 (4), 1002–1016.
- Yarram, S., Tran, C. and Dollery, B. E. (2021), 'The Impact of Rate Capping on Local Government Expenditure', *Policy and Politics* (in print).